Petition

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No.

IN THE

Supreme Court of the United States

October Term, 1981

COOPERS & LYBRAND,

Petitioner

v.

STANLEY L. SHARP,

Respondent

On Writ of Certiorari to the United States Court of Appeals for the Third Circuit

PETITION FOR WRIT OF CERTIORARI

Of Counsel:
HARRIS J. AMHOWITZ
General Counsel
Coopers & Lybrand
1251 Avenue of the Americas
New York, N. Y. 10020

MATTHEW J. BRODERICK
JEFFREY G. WEIL
RICHARD A. DEAK
DECHERT PRICE & RHOADS
3400 Centre Square West
1500 Market Street
Philadelphia, Pa. 19102
Attorneys for Petitioner

International Printing Co., 711 So. 50th St., Phila., Pa. 19143 — Tel. (215) 727-8711

QUESTIONS PRESENTED

1. Does the Securities Exchange Act of 1934 impose liability under the common law doctrine of *respondeat superior* when a jury has found that no partner in defendant accounting firm acted recklessly or with intent to defraud and that it was not foreseeable to defendant that plaintiffs would suffer any injury from defendant's allegedly misleading tax opinion letter?

2. Where plaintiffs claim to have been misled by defendant's tax opinion letter, should not plaintiffs have been required to prove under section 10(b) of the Securities Exchange Act of 1934 that they relied on that letter?

3. May a court award prejudgment interest to a party who has already recovered damages that include prejudgment interest at eight percent resulting from discounting calculations proposed by expert testimony and adopted by the jury?

PARTIES

This action is a class action brought by Stanley L. Sharp, an individual, against Coopers & Lybrand, a partnership. The judgment below was in favor of Stanley L. Sharp and two of his class members, Sam Geftic and H. James Conaway, Jr., and against Coopers & Lybrand. These are the four parties involved in this petition.

TABLE OF CONTENTS

	Page
QUESTIONS PRESENTED	i
PARTIES	i
TABLE OF AUTHORITIES	iv
OPINIONS BELOW	1
JURISDICTION	2
STATUTES INVOLVED	2
STATEMENT OF THE CASE	4
Background Facts	4
REASONS FOR GRANTING THE WRIT	8
I. The *Respondeat Superior* Issue	8
A. Review of This Case Is Necessary Because the Decisions in *Sharp* and Other Cases Applying *Respondeat Superior* to the Securities Exchange Act of 1934 Are Contrary to the Design of That Act, as Evidenced by the Clear Language of the Statute and Decisions of This Court	8
B. The Circuit Courts Are Divided Over and Apparently Confused by the Application of *Respondeat Superior* to Federal Securities Actions	13
II. The Reliance Issue	17
A. Review of This Case Is Necessary Because the Decision in *Sharp* Is Contrary to This Court's Decision in *Affiliated Ute*	17
B. The Third Circuit's Analysis of Mixed Misrepresentation and Omission Cases Is Contrary to That of the Two Other Circuits Which Have Considered the Question	21

TABLE OF CONTENTS (Continued)

Page

III. The Prejudgment Interest Issue 23

The Award of Prejudgment Interest Unjustly Compensates Plaintiffs Because the Damage Award Itself Was Already Increased to Compensate Plaintiffs for the Lost Use of Their Money 23

CONCLUSION 25

APPENDIX:

OPINIONS:

Circuit Court Opinion Dated April 28, 1981 ..... A1

Circuit Court Order Amending Opinion Dated June 5, 1981 ..... A39

District Court Opinion Dated February 19, 1976 .. A40

District Court Opinion Dated September 27, 1978 A49

District Court Opinion Dated June 26, 1979 ..... A82

District Court Opinion Dated June 11, 1980 ..... A112

ORDERS:

District Court Order Dated February 19, 1976 ... A119

District Court Order Dated March 17, 1978 ..... A120

District Court Order Dated September 27, 1978 .. A121

District Court Order Dated June 26, 1979 ..... A122

District Court Order Dated June 11, 1980 ..... A123

CIRCUIT COURT JUDGMENT DATED APRIL 28, 1981 ..... A125

DENIALS OF PETITION FOR REHEARING:

Dated May 27, 1981 ..... A127

Dated June 5, 1981 ..... A128

INTERROGATORIES TO THE JURY:

First Trial A129

Second Trial A133

TABLE OF AUTHORITIES

Cases: Page

Aaron v. SEC, 446 U. S. 680 (1980) 11, 12

Affiliated Ute Citizens of Utah v. United States, 406 U. S. 128 (1972) 18, 19, 21, 22, 23

Armstrong, Jones & Co. v. SEC, 421 F. 2d 359 (6th Cir.), cert. denied, 398 U. S. 958 (1970) 15

Carpenter v. Harris, Upham & Co., 594 F. 2d 388 (4th Cir.), cert. denied, 444 U. S. 868 (1979) 14

Carras v. Burns, 516 F. 2d 251 (4th Cir. 1975) 14

Chiarella v. U. S., 445 U. S. 222 (1980) 12

Christoffel v. E. F. Hutton & Co., 588 F. 2d 665 (9th Cir. 1978) 9, 14

Cutner v. Fried, 373 F. Supp. 4 (S. D. N. Y. 1974) 18

Ernst & Ernst v. Hochfelder, 425 U. S. 185 (1976) 7, 11, 13

Fey v. Walston & Co., 493 F. 2d 1036 (7th Cir. 1974) 15

Forman v. Ferro, [1980] Fed. Sec. L. Rep. ¶ 97,676 (E. D. N. Y. Oct. 22, 1980) 14

Gilbert v. Woods Marketing, Inc., 454 F. Supp. 745 (D. Minn. 1978) 18

Gordon v. Burr, 506 F. 2d 1080 (2d Cir. 1974) 15

Gould v. American-Hawaiian Steamship Co., 535 F. 2d 761 (3d Cir. 1976) 16

Haynes v. Anderson & Strudwick, Inc., 508 F. Supp. 1303 (E. D. Va. 1981) 14

Henricksen v. Henricksen, 640 F. 2d 880 (7th Cir. 1981) ... 15

Holloway v. Howerdd, 536 F. 2d 690 (6th Cir. 1976) 15

Huddleston v. Herman & MacLean, 640 F. 2d 534 (5th Cir. 1981) 21, 22

Johns Hopkins University v. Hutton, 422 F. 2d 1124 (4th Cir. 1970), cert. denied, 416 U. S. 916 (1974) 14

Kamen & Co. v. Paul H. Aschkar & Co., 382 F. 2d 689 (9th Cir. 1967), cert. dismissed, 393 U. S. 801 (1968) 14

TABLE OF AUTHORITIES (Continued)

Cases (Continued): Page

Lewis v. McGraw, 619 F. 2d 192 (2d Cir.), cert. denied, 101 S. Ct. 354 (1980) 18
Lewis v. Walston & Co., 487 F. 2d 617 (5th Cir. 1973) 15
Marbury Management, Inc. v. Kohn, 629 F. 2d 705 (2d Cir.), cert. denied, 101 S. Ct. 566 (1980) 15
Myzel v. Fields, 386 F. 2d 718 (8th Cir. 1967), cert. denied, 390 U. S. 951 (1968) 14
Paul F. Newton & Co. v. Texas Commerce Bank, 630 F. 2d 1111 (5th Cir. 1980) 15
Rifkin v. Crow, 574 F. 2d 256 (5th Cir. 1978) 18
Rochez Brothers, Inc. v. Rhoades, 527 F. 2d 880 (3d Cir. 1975) 9, 16
Rolf v. Blyth, Eastman, Dillion & Co., 570 F. 2d 38 (2d Cir.), cert. denied, 439 U. S. 1039 (1978) 15
Savino v. E. F. Hutton & Co., 507 F. Supp. 1225 (S. D. N. Y. 1981) 14
Schlick v. Penn-Dixie Cement Corp., 507 F. 2d 374 (2d Cir. 1974), cert. denied, 421 U. S. 976 (1975) 18
SEC v. Geon Industries, Inc., 531 F. 2d 39 (2d Cir. 1976) .. 15
SEC v. Lum's, Inc., 365 F. Supp. 1046 (S. D. N. Y. 1973) .. 15
SEC v. Management Dynamics, Inc., 515 F. 2d 801 (2d Cir. 1975) 15
SEC v. National Securities, Inc., 393 U. S. 453 (1969) 8
Shores v. Sklar, 647 F. 2d 462 (5th Cir. 1981) 22
Straub v. Vaisman & Co., 540 F. 2d 591 (3d Cir. 1976) 16
Thomas v. Duralite Co., 524 F. 2d 577 (3d Cir. 1975) 16
Touche Ross & Co. v. Redington, 442 U. S. 560 (1979) 12
Vervaecke v. Chiles, Heider & Co., 578 F. 2d 713 (8th Cir. 1978) 17, 22
Zweig v. Hearst Corp., 521 F. 2d 1129 (9th Cir.), cert. denied, 423 U. S. 1025 (1975) 14

TABLE OF AUTHORITIES (Continued)

Statutes:

	Page
Securities Exchange Act of 1933, Section 15	9, 10
Securities Exchange Act of 1934, Generally	4, 10
Securities Exchange Act of 1934, Rule 10b-5, 17 C. F. R. § 240.10b-5	3, et seq.
Securities Exchange Act of 1934, Section 10(b), 15 U. S. C. § 78j(b)	i, et seq.
Securities Exchange Act of 1934, Section 20	9, 10, 16, 17
Securities Exchange Act of 1934, Section 20(a), 15 U. S. C. § 78t(a)	3, et seq.
28 U. S. C. § 1254(1)	2

Authorities:

78 Cong. Rec. 8668 (1934)	10
Fischel, *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 Cal. L. Rev. 80 (1981)	12
H. R. Rep. No. 152, 73 Cong., 1st Sess. 26 (1933)	10
H. R. Rep. No. 1383, 73d Cong., 20 Sess. 26 (1934)	10

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ON WRIT OF CERTIORARI TO THE
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PETITION FOR WRIT OF CERTIORARI

The petitioner, Coopers & Lybrand, prays that a Writ of Certiorari issue to review the judgment and opinion of the United States Court of Appeals for the Third Circuit entered in this action on April 28, 1981, as amended June 5, 1981.

OPINIONS BELOW

The opinion of the Court of Appeals, dated April 28, 1981, as amended June 5, 1981, is reported at 649 F. 2d 175 and is reproduced in the Appendix to this petition.

The opinions of the United States District Court for the Eastern District of Pennsylvania dated February 19, 1976, September 27, 1978, June 26, 1979, and June 11, 1980 are reported at 70 F. R. D. 544, 457 F. Supp. 879, 83 F. R. D. 343, 491 F. Supp. 55, respectively, and are reproduced in the Appendix to this petition.

JURISDICTION

The judgment of the Court of Appeals for the Third Circuit was entered on April 28, 1981, and an amended opinion issued on June 5, 1981, the same date on which Coopers & Lybrand's petition for rehearing was denied. This petition for certiorari was filed within 90 days of that date. Jurisdiction of this Court is invoked under 28 U. S. C. § 1254(1).

STATUTES INVOLVED

1. Section 10(b) of the Securities Exchange Act of 1934, 15 U. S. C. § 78j(b), provides:

> Manipulative and deceptive devices.
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—
>
> • • •
>
> (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, any manipulative or deceptive device or contrivance in contravention of such rules and regulations as the Commission may prescribe as necessary or appropriate in the public interest or for the protection of investors.

2. Rule 10b-5 under the Securities Exchange Act of 1934, 17 C. F. R. § 240.10b-5, provides:

> Employment of manipulative and deceptive devices.
>
> It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange,
>
> (a) To employ any device, scheme, or artifice to defraud,
>
> (b) To make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, *or*
>
> (c) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

3. Section 20(a) of the Securities Exchange Act of 1934, 15 U. S. C. § 78t(a), provides:

> Liabilities of controlling persons.
>
> (a) Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

STATEMENT OF THE CASE

This case raises challenging questions about the judicial expansion of liability under the Securities Exchange Act of 1934 (the "1934 Act"). Although the 1934 Act represents an effort by Congress to balance protection of the public against indiscriminate liability of defendants, that balance has been jeopardized by a number of recent circuit court decisions, including the Third Circuit's here. For instead of respecting the Congressional decision to limit liability to fraudulent actors, the Third Circuit has chosen to render liable a defendant who was specifically found by the jury not to have acted with scienter. This was accomplished—not through any language of the 1934 Act—but through the common law doctrine of *respondeat superior*, which other circuits have refused to apply to the 1934 Act.

Moreover, the Third Circuit has now opened the floodgates on the reliance issue. Under the holding of the trial court, as affirmed by the Third Circuit, a plaintiff who did not read the allegedly misleading letter, as well as a plaintiff who never even heard of that letter, is presumed to have relied on it and need not carry the burden of proof on that issue.

Finally, the Third Circuit's decision not only distorts the 1934 Act's configuration of liability, but it affirms a grossly unfair and punitive award of damages by approving double recovery of prejudgment interest going back to 1971.

Background Facts

In 1971, Coopers & Lybrand ("C&L") wrote a tax opinion letter for Westland Minerals Corporation ("WMC"), the general partner in an oil and gas limited partnership. The letter, premised on facts provided by WMC, forecast tax consequences to purchasers of limited partnership interests. In the first sentence of the letter,

C&L explained that it had not verified the underlying facts provided by WMC and that its opinion must be so qualified.[1] Nevertheless, the letter was used by WMC to sell limited partnership interests. Some persons who bought into the WMC partnership never saw nor even heard of the C&L tax opinion letter. Others did not see it, but had it summarized for them in an incomplete way. Others saw the letter.

By 1972, the Securities and Exchange Commission ("SEC") suspected that WMC had acted improperly under the federal securities laws, and a complaint was filed by the SEC. That action was concluded in 1973, when WMC principals agreed to the entry of a consent decree against themselves and WMC. Thereafter, certain WMC principals were successfully prosecuted for criminal violations resulting from their misapplication of investors' funds.

Although neither the SEC nor the grand jury found any wrongdoing by C&L, the purchasers of these oil and gas limited partnerships, who had lost money when WMC went bankrupt, started this class action against C&L in 1975. They alleged that C&L had acted improperly under § 10(b) of the 1934 Act and its accompanying Rule 10b-5 by writing a tax opinion letter which involved misleading representations and omissions. Plaintiffs complained that they were not allowed the deduction predicted by C&L and that C&L knew or should have known its predicted deduction was not obtainable under the structure of the WMC tax shelter.

Plaintiffs' claims were bifurcated and, over C&L's objection, tried to two different juries. After a trial of the issues common to all members of the class, a jury found in answers to special interrogatories that although the opinion letter contained misrepresentations and omissions, no C&L partner intentionally or recklessly caused the mis-

1. The C&L letter is set forth in full at App. 106a-11a *infra*.

representation or omission. The jury also found that it was not foreseeable to C&L that any investor would be injured by its tax opinion letter. However, the jury found that a C&L employee who drafted the opinion letter had acted recklessly and that he had been inadequately supervised by C&L.[2]

Two years later, after additional discovery on the individual issues, the reliance, statute of limitations, due diligence, and damage issues of three class members were tried before a second jury.[3] Instructed by the court to presume reliance, the jury entered findings favorable to these three plaintiffs on the reliance and other individual issues.[4] The trial court then molded a verdict against C&L on two theories: that C&L was liable as a controlling person under § 20(a) of the 1934 Act and that C&L was strictly liable under the common law doctrine of *respondeat superior*. The lower court also awarded prejudgment interest in addition to the jury's award of damages, which in itself included a prejudgment interest factor of eight percent.

The Third Circuit affirmed the granting of a presumption of reliance to plaintiff, the entry of judgment in favor of the three plaintiffs, and the award of prejudgment interest. Although it rejected the trial court's holding of

2. The jury's answers to the special interrogatories are set forth at App. at 129a-32a *infra*.

3. Over C&L's objection, the trial court chose just three class members for a second jury trial on the individual issues. These plaintiffs were chosen because of their varying knowledge of and exposure to the C&L opinion letter. These plaintiffs were: 1) Stanley Sharp, who had never seen C&L's letter but had had it incompletely described to him; 2) Sam Geftic, who never saw nor even heard of the C&L letter until after he made his investment; and 3) H. James Conaway, Jr., Esq., who read the letter.

4. The second jury's answers to the special interrogatories are set forth at App. 133a-34a *infra*.

controlling person liability, which was improperly based on a finding of mere negligence, the Third Circuit affirmed judgment against C&L on the strict liability theory of *respondeat superior*, by which C&L was held absolutely liable for the wrongs of its employee.[5] Thus, the controlling person issue under § 20(a) was removed from the appeal process; and the judgment now stands or falls on *respondeat superior*.

It is C&L's position that *respondeat superior* is not applicable to § 10(b) and that Congress demonstrated its intent not to impose strict liability on controlling persons. Furthermore, this Court in *Ernst & Ernst v. Hochfelder*, 425 U. S. 185 (1976), held that a defendant cannot be liable under § 10(b) if he acted in good faith.

In addition, C&L contends that the award to plaintiffs of a presumption of reliance is contrary to the decisions of this Court and other circuit courts and improperly abrogates the rule that it is plaintiffs' burden to prove reliance in a § 10(b) case. This is particularly true of the presumption awarded to plaintiff Sharp, who did not read the letter, and to plaintiff Geftic, who never saw nor heard of the C&L tax opinion letter until well after his investment was made.

Finally, C&L believes the award of prejudgment interest is unfair and punitive here. Plaintiffs were compensated for the lost use of their money by the eight percent discount factor that was calculated into the jury's damage award. Therefore, an award of prejudgment interest results in double recovery of prejudgment interest.

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5. The Third Circuit found that the trial court's instructions on § 20(a) were improper. While the trial court had instructed the jury on inadequate supervision and bad faith, it had refused C&L's request to instruct the jury on culpable participation. The Third Circuit found that § 20(a) requires a finding of culpable participation, and that the jury should have been so instructed.

REASONS FOR GRANTING THE WRIT

I. The *Respondeat Superior* Issue.

A. Review of This Case Is Necessary Because the Decisions in *Sharp* and Other Cases Applying *Respondeat Superior* to the Securities Exchange Act of 1934 Are Contrary to the Design of That Act, as Evidenced by the Clear Language of the Statute and Decisions of This Court.

Application of *respondeat superior* to § 10(b) of the 1934 Act destroys a carefully drawn Congressional design. Concerned with secondary liability, Congress enacted § 20(a) of the 1934 Act, the controlling person provision. That provision regulates and limits the liability of parties who have committed no direct violation of the 1934 Act, but who control persons who have.[6] Importantly, § 20(a) refrains from imposing liability without fault; it requires a defendant to have directly or indirectly induced the fraud. Rejecting an insurer's standard of absolute liability for controlling persons, Congress crafted the following standard of secondary liability in § 20(a):

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, *unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.* [emphasis added]

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6. To analyze properly Congress's intent with respect to the application of *respondeat superior* to § 10(b), it is necessary to consider § 20. As the Court indicated in *SEC v. National Securities, Inc.*, 393 U. S. 453, 466 (1969), "[T]he interdependence of the various sections of the securities laws is certainly a relevant factor in any interpretation of the language Congress has chosen . . . ."

Therefore, to apply *respondeat superior* would contradict the intent and letter of § 20(a). For contrary to § 20(a), the common law doctrine of *respondeat superior* makes employers absolutely liable for all wrongs of employees and converts employers into insurers without regard to their fault. As at least one court has recognized, *respondeat superior* emasculates § 20(a):

> If we were to apply *respondeat superior*, the availability of this [Section 20(a)] good faith defense would be bypassed. Therefore, to use *respondeat superior* for imposing secondary liability would not advance the legislative purpose of the 1934 Act and, in fact would also undermine the Congressional intent by emasculating Section 20(a).

Rochez Brothers, Inc. v. Rhoades, 527 F. 2d 880, 885 (3d Cir. 1975). See also, *Christoffel v. E. F. Hutton & Co.*, 588 F. 2d 665, 668 (9th Cir. 1978) ("[C]ongress also intended a more restrictive meaning than that embraced by agency principles by also requiring some kind of participation by the controlling person in the activities of the controlled person which are claimed to be violative of the securities laws.")

The legislative history of the federal securities laws confirms the letter of the current law: *respondeat superior* is inapplicable to federal securities actions. The Securities Act of 1933 (the "1933 Act") contains a "controlling person" provision, § 15, very similar to § 20 of the 1934 Act. As originally enacted, § 15 of the 1933 Act contained a provision which specifically held principals to a strict liability standard. It provided:

> Every person who, by or through stock ownership, agency or otherwise, or who, pursuant or in connection with an agreement or understanding with one

> or more other persons by or through stock ownership, agency, or otherwise, controls any person liable under section 11 or 12, shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable.[7]

After complaints from the business community that such a standard was "too drastic and interfered with business," [8] Congress, on the same day it enacted the 1934 Act, repealed the strict liability standard for § 15.[9] It would be absurd to conclude that on the same day that Congress rejected employer strict liability in the 1933 Act, it meant to adopt employer strict liability in the companion 1934 Act.[10]

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7. H. R. Rep. No. 152, 73 Cong., 1st Sess. 26 (1933).

8. 78 Cong. Rec. 8668 (1934) (remarks of Congressman Fletcher).

9. Section 15 of the 1933 Act has been amended to provide that a controlling person may be liable "unless the controlling person had no knowledge of a reasonable ground to believe in the existence of the facts by reason of which the liability of the controlled person is alleged to exist."

10. There is no merit to the argument that § 20 was meant only to deal with the problem of "dummy directors." Although the term "control" is not defined in the 1934 Act, the House Report on § 20 clarifies what Congress intended:

> In [§ 20] when reference is made to "control," the term is intended to include actual control as well as what has been called legally enforceable control. It was thought undesirable to attempt to define the term. . . . A few examples of the methods used [for control] are stock ownership, lease, contract, and agency. [citation omitted.] H. R. Rep. No. 1383, 73d Cong., 20 Sess. 26 (1934).

Thus, the legislative history of § 20 reveals that Congress meant to include all types of control relationships, including employment ("agency"), within the scope of § 20.

The meaning of this Congressional intent has not been lost on this Court. In *Ernst & Ernst v. Hochfelder*, 425 U. S. 185 (1976), this Court held that scienter is a necessary element of a § 10(b) cause of action; and it defined "scienter" as a mental state embracing intent to deceive, manipulate, or defraud. In so holding, the Court ruled that defendant, not some non-party, must have acted culpably with intent to defraud to be liable under § 10(b). The fact that someone else acted with scienter does not prove a § 10(b) claim against a defendant who has not culpably participated in the fraud.

In this case, C&L has been held liable although a jury found that no C&L partner acted recklessly or intentionally with respect to any misrepresentation or omission. Moreover, the jury also found that C&L could not foresee that plaintiffs would be injured by C&L's tax opinion letter. For the trial court to have circumvented these findings by unilaterally imposing *respondeat superior* liability on C&L is contrary to *Hochfelder*. For, as *Hochfelder* held, a defendant may not be liable under § 10(b) unless he acted with scienter, *i.e.*, intent to defraud.[11]

Since *Hochfelder*, this Court has reaffirmed the limited scope of the securities laws. In *Aaron v. SEC*, 446 U. S. 680 (1980), the Court refused to hold a supervisor to a liability standard lower than fraud. The Court rejected a negligence standard of § 10(b) liability where the defendant, like C&L here, was accused of inadequate supervision of a lower level employee. Although *Aaron* was an SEC enforcement action, the Court's reasoning applies to private civil actions as well: "[S]cienter is an element of a violation of § 10b and Rule 10b-5, *regardless of the*

11. *Hochfelder* quotes from a Senate Report of the 1934 Act which provides: "The defendant may escape liability by showing that the statement was made in *good faith*." *Hochfelder*, 206.

identity of the plaintiff or the nature of the relief sought." *Id.*, 691 (emphasis added). In short, *Aaron* holds that scienter is an essential element of a § 10(b) claim and that the 1934 Act was not designed to punish mere negligence.

The *Aaron* Court issued a strong warning against unreasonable expansion of the federal securities laws:

> "[G]eneralized references to the 'remedial purposes'" of the securities laws "will not justify reading a provision 'more broadly than its language and the statutory scheme reasonably permit.'" . . . Thus, if the language of a provision of the securities laws is sufficiently clear in its context and not at odds with the legislative history, it is unnecessary "to examine the additional considerations of 'policy' . . . that may have influenced the lawmakers in their formulation of the statute."

Id., 695 quoting from *Touche Ross & Co. v. Redington*, 442 U. S. 560 (1979).

This warning was repeated in *Chiarella v. U. S.*, 445 U. S. 222 (1980):

> As we have emphasized before, the 1934 Act cannot be read "more broadly than its language and the statutory scheme reasonably permit." [citations omitted] Section 10(b) is aptly described as a catchall provision, but what it catches must be fraud.

Id., 234-35.

In an article entitled *Secondary Liability Under Section 10(b) of the Securities Act of 1934*, 69 Cal. L. Rev. 80 (1981), Professor Fischel argues that "the theory of secondary liability is no longer viable in light of recent

Supreme Court decisions strictly interpreting the federal securities laws." *Id.*, 82. The article further points out that the recognition of strict liability under *respondeat superior* effectively eliminates the good faith defense provided to controlling persons by § 20(a). Lastly, the article concludes that a defendant "that does no more than employ an individual who engages in prohibited conduct . . . has not itself engaged in a manipulative or deceptive practice and certainly has not acted with scienter as required by *Hochfelder*." *Id.*, 107.

To override § 20(a) with the common law doctrine of *respondeat superior* improperly expands the 1934 Act; for *respondeat superior* captures everything, not just fraud. Its sweep is thus too wide to be artificially grafted onto the 1934 Act.[12]

B. The Circuit Courts Are Divided Over and Apparently Confused by the Application of *Respondeat Superior* to Federal Securities Actions.

The Circuit Courts of Appeals have taken varying approaches to the *respondeat superior* issue. Some refuse to apply it to the 1934 Act at all because of § 20(a). Some have applied it, but only to broker-dealers. And now, the Third Circuit has applied it to an even wider group. The *Sharp* case affords this Court the opportunity to end the disparate treatment similar litigants now experience under the 1934 Act and to clarify the law with respect to this important and recurring issue.[13]

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12. It should be noted that the 1934 Act, with its requirement of scienter, does not deprive plaintiffs of any rights. It only adds to pre-existing common law rights which are still available to protect plaintiffs against negligence.

13. Within the past year the Second, Third, Fifth, and Seventh Circuits have all decided at least one major case involving the application of *respondeat superior* to the 1934 Act. *See* discussion at 14-16 *infra*. District Courts during the past year have been

The Ninth Circuit has repeatedly held that *respondeat superior* is not applicable to § 10(b) actions, whether a broker-dealer is involved or not. In *Kamen & Co. v. Paul H. Aschkar & Co.*, 382 F. 2d 689 (9th Cir. 1967), *cert. dismissed*, 393 U. S. 801 (1968), the Ninth Circuit ruled that § 20(a) supplants the common law doctrine of *respondeat superior*; and the court has consistently reaffirmed its *Kamen* ruling. See, *Christoffel v. E. F. Hutton & Co.*, 588 F. 2d 665 (9th Cir. 1978); *Zweig v. Hearst Corp.*, 521 F. 2d 1129 (9th Cir.), *cert. denied*, 423 U. S. 1025 (1975).

Similarly, the Fourth and Eighth Circuits do not allow *respondeat superior* to override § 20(a). The Fourth Circuit, which has recently altered its view, now holds that not even broker-dealers are strictly liable for the securities law violations of their employees. In *Carpenter v. Harris, Upham & Co.*, 594 F. 2d 388, 394 (4th Cir.), *cert. denied*, 444 U. S. 868 (1979), the Court noted:

> While the standards of supervision (for a broker-dealer) may be stringent, this does not create absolute liability for every violation of the securities laws committed by a supervised individual.[14]

The Eighth Circuit, in *Myzel v. Fields*, 386 F. 2d 718, 738 (8th Cir. 1967), *cert. denied*, 390 U. S. 951 (1968), has noted that the liability of controlling persons "is governed neither by principles of agency or conspiracy."

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13. (Cont'd.)
similarly occupied with the issue. *See e.g., Haynes v. Anderson & Strudwick, Inc.*, 508 F. Supp. 1303 (E. D. Va. 1981); *Savino v. E. F. Hutton & Co.*, 507 F. Supp. 1225 (S. D. N. Y. 1981); *Forman v. Ferro*, [1980] Fed. Sec. L. Rep. ¶ 97,676 (E. D. N. Y. Oct. 22, 1980).

14. In *Haynes v. Anderson & Strudwick, Inc.*, 508 F. Supp. 1303 (E. D. Va. 1981), the court explicitly interpreted *Carpenter* as having overruled, *sub silentio*, *Johns Hopkins University v. Hutton*, 422 F. 2d 1124 (4th Cir. 1970), *cert. denied*, 416 U. S. 916 (1974), and *Carras v. Burns*, 516 F. 2d 251 (4th Cir. 1975).

The Second Circuit has taken the opposite view. Although in *Gordon v. Burr*, 506 F. 2d 1080 (2d Cir. 1974), the Second Circuit cited with approval *SEC v. Lum's, Inc.*, 365 F. Supp. 1046 (S. D. N. Y. 1973), a case which held that *respondeat superior* was not applicable, thereafter it changed its course. In *Marbury Management, Inc. v. Kohn*, 629 F. 2d 705 (2d Cir.), *cert. denied*, 101 S. Ct. 566 (1980), the Second Circuit applied the doctrine of *respondeat superior* to a broker-dealer defending a § 10(b) claim. Although the court did not explicitly limit its holding to broker-dealer cases, all of the cases cited in support of its ruling were broker-dealer cases. In addition, the court's discussion of *respondeat superior* is replete with specific references to broker-dealers. For example, the court stated: "[T]here is no warrant for believing that Section 20(a) was intended to narrow the remedies *of the customers of brokerage houses* or to create a novel defense in cases otherwise governed by traditional agency principles." (emphasis added) *Id.*, 716.[15]

The Second Circuit now stands with the Fifth,[16] Sixth,[17] and Seventh[18] Circuits, all of which apply *respondeat superior* to broker-dealers.

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15. Several Second Circuit cases have discussed the applicability of *respondeat superior*. *See, e.g., Rolf v. Blyth, Eastman, Dillon & Co.*, 570 F. 2d 38 (2d Cir.), *cert. denied*, 439 U. S. 1039 (1978); *SEC v. Geon Industries, Inc.*, 531 F. 2d 39 (2d Cir. 1976); *SEC v. Management Dynamics, Inc.*, 515 F. 2d 801 (2d Cir. 1975).

16. *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F. 2d 1111 (5th Cir. 1980); *Lewis v. Walston & Co.*, 487 F. 2d 617 (5th Cir. 1973).

17. *Holloway v. Howerdd*, 536 F. 2d 690 (6th Cir. 1976); *Armstrong, Jones & Co. v. SEC*, 421 F. 2d 359 (6th Cir.), *cert. denied*, 398 U. S. 958 (1970).

18. *Henricksen v. Henricksen*, 640 F. 2d 880 (7th Cir. 1981); *Fey v. Walston & Co.*, 493 F. 2d 1036 (7th Cir. 1974).

The Third Circuit, like the Fourth and Second Circuits, has experienced false starts and changes of direction in dealing with the *respondeat superior* issue. Indeed, the Third Circuit has gone from one extreme to the other. Whereas it once held that § 20(a) preempts *respondeat superior*, in *Sharp* it applies *respondeat superior* to an accounting firm that is not a broker-dealer.

In *Gould v. American-Hawaiian Steamship Co.*, 535 F. 2d 761, 778-79 (3d Cir. 1976), the court stated: "This court has recently held [in *Rochez Brothers, Inc. v. Rhoades*, 527 F. 2d 880 (3d Cir. 1975)] that ordinary agency principles are not applicable in determining secondary liability in securities violation cases." [19] Until recently, therefore, it appeared that the Third Circuit, like the Fourth, Eighth, and Ninth Circuits, had rejected the applicability of *respondeat superior* to federal securities actions.

After *Sharp*, however, the Third Circuit now stands alone in its interpretation of *respondeat superior* and § 10(b) and perhaps alone in the extent of its confusion. For while the Third Circuit now believes *respondeat superior* overrides § 20, *Sharp* conditions the application of *respondeat superior* upon a finding of negligent supervision:

> [T]he expectation that investment decisions would be made on the basis of the opinion letter required the [C&L] firm to exercise a "stringent duty to supervise" its employees in drafting and issuing the letter.
>
> . . . .
>
> [F]ailure to perform this duty will expose [the defendant] to liability for their [employees'] violations

19. *See also, Straub v. Vaisman & Co.*, 540 F. 2d 591 (3d Cir. 1976); *Thomas v. Duralite Co.*, 524 F. 2d 577 (3d Cir. 1975); and *Rochez Brothers, Inc. v. Rhoades*, 527 F. 2d 880 (3d Cir. 1975).

of rule 10b-5 under the doctrine of *respondeat superior.*

Sharp, 184-85.

In *Sharp,* the Third Circuit uniquely and inconsistently combines theories of negligence with strict liability by premising *respondeat superior* liability on an employer's inadequate supervision of his employees. Thus, the Third Circuit confuses the *respondeat superior* issue even more by adding a fourth to an already crowded field of possibilities: (1) *respondeat superior* does not apply to § 10(b) because of § 20; (2) *respondeat superior* applies regardless of § 20; (3) *respondeat superior* applies, but only to broker-dealers; and (4) (in *Sharp*) *respondeat superior* applies where an employer breaches a duty to supervise, whether or not the employer is a broker-dealer.[20] Review by this Court is necessary to resolve these differences.

II. The Reliance Issue.

A. Review of This Case Is Necessary Because the Decision in *Sharp* Is Contrary to This Court's Decision in *Affiliated Ute.*

Reliance is a necessary element in § 10(b) cases. Indeed, it is the reliance element which "preserves the basic concept that causation must be proved else defendants could be held liable to all the world." *Vervaecke v. Chiles, Heider & Co.,* 578 F. 2d 713, 715 (8th Cir. 1978). In this case, the Third Circuit has removed that protective barrier and approved liability even where a plaintiff never saw nor heard of C&L's opinion letter.

20. The *Sharp* court extended the application of *respondeat superior* from broker-dealers to all defendants who have reason to believe that the document containing the misrepresentations or omissions is designed to influence the investing public. *Sharp,* therefore, extends almost limitlessly the application of the doctrine.

In gifting plaintiffs with a presumption of reliance, the Third Circuit professes obeisance to *Affiliated Ute Citizens of Utah v. United States*, 406 U. S. 128 (1972), wherein the Supreme Court narrowly amended the traditional rule that plaintiffs must prove reliance. In *Affiliated Ute*, the Court recognized a presumption of reliance in the special circumstances involving primarily a failure by defendant to disclose information. In that unusual situation, where the defendant stood mute, the presumption was warranted by the difficulty plaintiff faced in proving he relied on something not said.[21] In *Sharp*, the Third Circuit has transformed this carefully limited retreat from the reliance requirement into a full scale surrender of the rule that a plaintiff must prove reliance. Plaintiffs in the Third Circuit are no longer required to prove reliance when defendant's alleged wrong is, not standing mute, but the publication of an allegedly misleading letter that contains misrepresentations and omissions.

In *Sharp*, the jury found that the allegedly fraudulent opinion letter involved both misrepresentations and omissions. Plaintiff argued that the presumption applied because omissions were involved. C&L argued that because plaintiffs could easily prove whether or not they had relied on the opinion letter in making their investment decision, no presumption was necessary. Furthermore, C&L contended that the presumption was not appropriate because the alleged fraud resulted primarily from a misrepresenta-

21. *See Lewis v. McGraw*, 619 F. 2d 192, 195 (2d Cir.), *cert. denied*, 101 S. Ct. 354 (1980), where the court held that the presumption of reliance is limited to pure omission cases where reliance is unduly burdensome to prove. *See also Rifkin v. Crow*, 574 F. 2d 256, 262-63 (5th Cir. 1978); *Schlick v. Penn-Dixie Cement Corp.*, 507 F. 2d 374, 380-81, (2d Cir. 1974), *cert. denied*, 421 U. S. 976 (1975); *Gilbert v. Woods Marketing, Inc.*, 454 F. Supp. 745, 749 (D. Minn. 1978); *Cutner v. Fried*, 373 F. Supp. 4, 12 (S. D. N. Y. 1974).

tion of a tax deduction, and that the omissions, if any, were secondary. The Third Circuit affirmed the trial court's grant of a presumption, adopting a new standard which it termed the "flexible approach." Under this standard, which the Third Circuit characterized as consistent with *Affiliated Ute*, there is no determination of whether a case involves primarily misrepresentations or primarily omissions. Rather, the court simply decides as a factual matter whether it is likely plaintiff relied. In the Third Circuit's own words, "Considering the likelihood that investors would rely on the opinion letter, we conclude that the trial judge properly placed the burden of refuting a presumption of reliance on the appellant [C&L]."[22] *Sharp*, 189.

The Third Circuit's decision in *Sharp* is contrary to *Affiliated Ute* because the court did not, as directed by *Affiliated Ute*, determine whether the case involves primarily omissions. In *Affiliated Ute*, defendants were held to have stood mute; and plaintiffs were granted a presumption to overcome the difficulty of proving a negative: reliance on something not said. Recognizing how unusual it is to shift the burden of proof from plaintiff to defendant, the *Affiliated Ute* Court expressly limited its exception to cases involving primarily omissions. Because *Affiliated Ute* applies only to cases involving primarily omissions, the Third Circuit should have determined whether or not this case involves primarily omissions or primarily misrepresentations. Once deciding that, the presumption either does or does not apply.

In addition, the Third Circuit failed to consider whether *Sharp* involves a special circumstance wherein plaintiffs could not prove reliance. Because the presumption awarded in *Affiliated Ute* was founded on the diffi-

22. The Third Circuit's reasoning is tautological: reliance is presumed when the evidence shows that it is likely plaintiffs relied.

culty of plaintiff's proof, the *Sharp* court should have focused on whether it was difficult for the plaintiffs here to show whether they relied on the C&L letter.

However, instead of requiring the plaintiffs to prove reliance, the *Sharp* court made its own independent fact-finding that plaintiffs relied. *Sharp* holds that a presumption will be awarded whenever it appears to the court from the evidence at trial that investors relied on the opinion letter. Thus, even in a jury case such as this, the judge decides the reliance issue before it goes to the jury. Moreover, the way in which the court below exercised this unprecedented fact-finding is assurance to all future § 10(b) plaintiffs that they will never have to prove reliance. For *Sharp* awards the presumption to a plaintiff (Geftic) who never saw the opinion letter nor even heard of it.[23] If plaintiff Geftic, who admitted he never saw nor heard of C&L's letter, receives the presumption because of the likelihood he relied on that letter then all other plaintiffs in all other cases involving omissions can expect to receive the presumption.

In fact, the Third Circuit has not adopted a "flexible approach" test for a narrow group of § 10(b) cases. Rather, it has opened the floodgates by adopting a rule that reliance is to be presumed in all § 10(b) cases alleging omissions[24]—even where the case involves primarily misrep-

23. The trial court awarded the presumption of reliance on the basis that this case involves omissions in addition to misrepresentations. It rejected plaintiff's fraud-on-the-market theory. Here the security in question had a set price that did not fluctuate in response to market stimuli. Moreover, there was no "open market" for these limited partnership interests. WMC's target group of buyers consisted of high income, sophisticated investors who were believed to be looking for tax shelters.

24. The ease of characterizing a classic misrepresentation as a misrepresentation and omission was distinctly brought out in a colloquy between plaintiffs' counsel, Mr. Mann, and Judge Aldisert, the author of the *Sharp* opinion.

resentations and where it is easy for plaintiffs to prove whether they relied on defendant.

B. The Third Circuit's Analysis of Mixed Misrepresentation and Omission Cases Is Contrary to That of the Two Other Circuits Which Have Considered the Question.

Both of the other circuits to consider the award of a presumption of reliance in mixed misrepresentation and omission cases have held that the presumption does not apply unless the case involves primarily omissions.

In *Huddleston v. Herman & MacLean*, 640 F. 2d 534 (5th Cir. 1981), the Fifth Circuit refused to apply the *Affiliated Ute* presumption in a mixed misrepresentations/omissions case. Keying its analysis to the Supreme Court's language in *Affiliated Ute*, the Fifth Circuit required a preliminary determination of whether any given case is *primarily* a misrepresentations or *primarily* an omissions case. If it is primarily an omissions case, the *Affiliated Ute* presumption applies. However, if it is primarily a misrepresentations case, the presumption does not apply. As the Fifth Circuit held:

> It is, therefore, necessary to characterize the facts in a Rule 10b-5 case as involving either primarily a failure to disclose . . . or, on the other hand, primarily a misstatement or failure to state a fact necessary to

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24. (Cont'd.)

Mr. Mann: The point that I want to make is that . . . the fault of [the C&L letter] is a very, very, very basic omission.

Judge Aldisert: Well it could be argued both ways.

Mr. Mann: It could be argued both ways—

Judge Aldisert: "I represent to you that you're going to get a double deduction. Well you're not going to get a double deduction." I think that's a classic misrepresentation.

Transcript of Oral Argument, March 19, 1981, at 52.

> make those statements made not misleading . . . . This case, involving alleged misstatements and omissions in a prospectus published pursuant to a public offering, cannot properly be characterized as an omissions case of the type for which the *Affiliated Ute* presumption was fashioned. The defendants did not "stand mute" in the face of a duty to disclose as did the defendants in *Affiliated Ute*. . . . This is not a case in which difficulties of proof of reliance require the application of the *Affiliated Ute* presumption.

Huddleston, 548.[25]

Similarly, the Eighth Circuit has refused to apply a presumption of reliance to a mixed misrepresentations/omissions case where misrepresentations predominated. In *Vervaecke v. Chiles, Heider & Co.*, 578 F. 2d 713 (8th Cir. 1978), the court found that although the defendant's offering statement contained alleged omissions and misrepresentations, the misrepresentations predominated. The court's language reflects a belief in the *Affiliated Ute* and *Huddleston* methodology, requiring an initial determination of whether a case is primarily one of misrepresentations or omissions. The Eighth Circuit said:

> However, we do not think that dispensing with an initial showing of reliance and substituting a presumption of causation in fact in *all* kinds of 10b-5 fraud is necessary, and that it is not appropriate to apply the *Affiliated Ute* test to this case involving primarily *misrepresentation* . . . .

Vervaecke, 717.

25. In *Shores v. Sklar*, 647 F. 2d 462 (5th Cir. 1981), the Fifth Circuit sitting *en banc* again discussed whether a presumption of reliance is appropriate in a mixed misrepresentation/omission case but did not find it necessary to resolve the issue. Thus, *Huddleston* is still the prevailing Fifth Circuit law on this point.

Aside from *Sharp*, there are no circuit court opinions which apply the so-called "flexible approach" test to a mixed misrepresentations/omissions case. The Fifth and Eighth Circuits, which have addressed the issue, tailor their analyses to the *Affiliated Ute* language implying that a presumption applies only where a case involves "primarily a failure to disclose." Thus, the Third Circuit is in direct conflict with other circuits in its rejection of that methodology. Instead of deciding whether defendant's opinion letter involved primarily misrepresentations or primarily omissions, the *Sharp* court presumed reliance because it was likely "investors would rely on the opinion letter." *Sharp*, 189.

III. The Prejudgment Interest Issue.

The Award of Prejudgment Interest Unjustly Compensates Plaintiffs Because the Damage Award Itself Was Already Increased to Compensate Plaintiffs for the Lost Use of Their Money.

The Third Circuit affirmed the trial court's award of prejudgment interest because, in the court's own words, "it gave the plaintiffs some compensation for losing the use of the money prior to judgment."[26] *Sharp*, 193. That award represents a gross injustice, not only because damages here were unliquidated and C&L never had use of plaintiffs' money, but because plaintiffs had already been

26. After a request for rehearing by C&L, the Third Circuit amended its original opinion in the area of prejudgment interest. In its original opinion the Third Circuit was confused by the mathematics of the discount factor and incorrectly held: "Application of the discount factor did not *raise* the damages claimed by plaintiffs, but *lowered* them." App. at 39a *infra*. In its Petition for Rehearing C&L demonstrated that the court was wrong; the discount factor did raise damages. On June 5, 1981, the court issued a revised opinion which justified its original affirmance of prejudgment interest, but on different grounds.

awarded eight percent prejudgment interest in the damage calculation adopted by the jury.

In *Sharp*, the Third Circuit approved the out-of-pocket measure of damages, which measures the difference between the "actual value" of the security and what plaintiffs paid for it. *Sharp*, 190. The first step in the determination of damages, therefore, was for the jury to determine the "actual value" of plaintiffs' investment in 1971. This was done by measuring potential well production at the time of purchase in 1971. Both plaintiffs' and defendant's experts agreed at trial that the projected income stream from these wells had to be discounted back to 1971 dollars to account for the fact that the value of the return was not in hand in 1971. The return of each well was thus reduced, or discounted, by eight percent. The "actual value" of a plaintiff's well was then deducted from what the plaintiff paid for the well, and the difference was plaintiff's damage. Accordingly, because the "actual value" was reduced eight percent by discounting, each plaintiff's damages were *increased* by eight percent to account for the lost use of money that was not in hand in 1971. Therefore, plaintiffs have already received an award of prejudgment interest in excess of the legal rate of six percent. They are entitled to no more.[27]

27. The Third Circuit's imposition of double prejudgment interest could result in an additional recovery of $1.4 million by the purported class. This amount is in stark contrast to the $7,500 C&L was paid for doing the tax opinion letter. Moreover, because the Third Circuit remanded the damage question, it should not have approved the award of prejudgment interest. Without a damage calculation of record, the Third Circuit could not conclusively determine whether an award of prejudgment interest was also a component of the damage award. By deciding a question intimately related to damages before the damage question was retried, the court considered the issue before it was ripe and, in effect, rendered an advisory opinion.

CONCLUSION

This case presents two important and recurring issues under the Securities Exchange Act of 1934, namely: the judicial expansion of § 10(b) liability by application of the common law doctrine of *respondeat superior,* and the abandonment of the general rule that plaintiffs must prove their reliance on the allegedly fraudulent activity. In addition, this case presents a gross injustice whereby defendant, Coopers & Lybrand, has been doubly taxed for prejudgment interest.

Accordingly, a writ of certiorari should issue to review the judgment and opinion of the United States Court of Appeals for the Third Circuit entered in *Sharp v. Coopers & Lybrand* on April 28, 1981, as amended June 5, 1981.

Respectfully submitted,

MATTHEW J. BRODERICK
JEFFREY G. WEIL
RICHARD A. DEAK
Dechert Price & Rhoads
3400 Centre Square West
1500 Market Street
Philadelphia, Pa. 19102
Attorneys for Petitioner

Of Counsel:
HARRIS J. AMHOWITZ
General Counsel
Coopers & Lybrand
1251 Avenue of the Americas
New York, N. Y. 10020

September 1, 1981

Appendix.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 80-2229

SHARP, STANLEY L.

v.

COOPERS & LYBRAND,

Appellant

APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

(D. C. Civil No. 75-01313)

Argued March 19, 1981
Before: ALDISERT and HIGGINBOTHAM, *Circuit Judges*, and MARKEY, *Chief Judge.**

(Filed April 28, 1981)

OPINION OF THE COURT

ALDISERT, *Circuit Judge.*

This appeal from verdicts in favor of the three named plaintiffs in a securities fraud class action raises several

* Honorable Howard T. Markey, of the United States Court of Customs and Patent Appeals, sitting by designation.

important questions under the antifraud provisions of the Securities Exchange Act of 1934. Specifically, we are asked to decide whether the district judge properly instructed the jury on imputed or secondary liability, on § 20(a) of the Act, on reliance, and on the measure of damages. For the reasons below, we affirm on all issues except the measure of damages, which we reverse and remand for a new trial.

I.

The factual setting of this case [1] combines Caribbean intrigue, creative accounting, and high finance against the backdrop of investors attempting to limit their tax obligations. Westland Minerals Corporation was the promoter of a venture, the "Ohio Program," in which multiple limited partnerships were formed for the purpose of drilling for oil and gas. WMC sold interests in each of these partnerships from July 22, 1971, through early July, 1972. Each limited partnership was to spend $140,000 on drilling and developing a well. Of this amount, $65,000 was to be raised from contributions by investors in the partnership, and the balance from "suitable banks or other lending institutions."

As part of its sales presentation, WMC used a tax opinion letter issued by the accounting firm of Coopers

1. The district court published four opinions in this case, which, taken collectively, provide a thorough recitation of the material facts. *Sharp v. Coopers & Lybrand*, 70 F. R. D. 544 (E. D. Pa. 1976) (granting class certification); *Sharp v. Coopers & Lybrand*, 457 F. Supp. 879 (E. D. Pa. 1978) (regarding motions following the first trial on the class issues); *Sharp v. Coopers & Lybrand*, 83 F. R. D. 343 (E. D. Pa. 1979) (discussing interrogatories and the damages theory employed at the second trial on the individual issues); *Sharp v. Coopers & Lybrand*, 491 F. Supp. 55 (E. D. Pa. 1980) (interpreting the jury's answers to interrogatories and forming a judgment). Our discussion of the facts is therefore abbreviated.

& Lybrand, the appellant. WMC requested the letter in April, 1971, in behalf of one investor, Muhammed Ali, and on July 22, 1971, an opinion letter signed by a Coopers & Lybrand partner in the firm name was sent to the president of WMC. The letter stated that "based solely on the facts contained [in the WMC Limited Partnership Agreement] and without verification by us," a limited partner who contributed $65,000 in cash could deduct approximately $128,000 on his 1971 tax return. Herman Higgins, a tax supervisor employed by Coopers & Lybrand who worked directly under the supervision of four partners, drafted the letter. In October, 1971, Higgins told David Wright, a partner at Coopers & Lybrand, that WMC was showing copies of the letter to investors as part of its sales program, and Wright decided that a more complete letter should be drafted for those purposes. On October 11, 1971, Wright sent to WMC a revised letter, which he signed in the name of Coopers & Lybrand.

Under the investment plan, investors would purchase partnership shares in WMC's Ohio Program, with the money raised to be used in oil drilling. The investors would be limited partners in the sense that their liability would be limited, but their participation in the profits would be quite extensive once the oil started to flow. The plan's main attraction was the investors' ability to deduct twice the amount invested from their federal income tax returns in the first year of investment. The reason for this double deduction was that WMC would borrow on a nonrecourse basis, secured only by the oil wells, an amount of money approximately equal to that invested. Because the outside investors received their interests as limited partners, they did not subject themselves to liability on the loans merely by being partners; because the loans were nonrecourse, they were also not subject to them by explicit agreement.

The tax benefit arose because oil drilling requires large initial noncapital expenditures before any recovery can occur. These expenditures would be incurred in 1971, the year of investment. The partnership agreement allowed the profits and losses to be passed through the partnership to the partners. Not only would they be able to claim a total loss for the money actually invested, but they would also be able to claim a loss for the money borrowed and spent on the oil wells. The result was that each investor was able to deduct twice what he actually invested as ordinary (noncapital) losses, and could recover his investment in the first year by tax savings if he was in a fifty percent or higher tax bracket.

The practical problem with this is that banks are seldom if ever willing to lend money for oil drilling when their only security is the oil well. The reason is obvious: the well may not produce, and the bank will then have no security. Obtaining large amounts of loans was crucial to the scheme. Higgins, the Coopers & Lybrand associate, proposed a solution. He suggested that WMC borrow the money from a bank, and then use the money borrowed to purchase savings certificates from the bank, which the bank would hold as collateral. The net result of this arrangement was a paper transaction, by which WMC obtained loans on paper without actually receiving the money.[2] WMC decided to transact these loans through a bank in the Bahamas that it acquired in September, 1971, before Coopers & Lybrand issued the second opinion letter. The scheme began to unravel when WMC was in-

2. Although the record is unclear, the additional money needed to drill each well apparently came from the investments of subsequent limited partners, converting the scheme from a tax shelter to a "Ponzi scheme," in which two investors were necessary to fulfill the obligations owed to one. *See Cunningham v. Brown*, 265 U. S. 1 (1924).

dicted for securities violations. The IRS began denying the deductions taken by the investors, the wells were frequently dry, and WMC collapsed.

Stanley Sharp filed this suit on behalf of himself and 210 other WMC investors similarly situated on May 8, 1975, alleging violations of § 10(b) of the Securities Exchange Act of 1934, 15 U. S. C. § 78j(b), and Securities Exchange Commission rule 10b-5, 17 C. F. R. § 240.10b-5.[3] The trial judge granted class certification, and a jury trial of the class issues was held from February 27 through March 10, 1978. By answers to special interrogatories, the jury found that the October 11, 1971, tax opinion letter contained material misrepresentations and omissions, and that Herman Higgins had acted recklessly and intentionally. Although the jury found that no partner of Coopers & Lybrand had acted with scienter in causing the omissions and misrepresentations, the district court concluded as a matter of law that the firm was liable under the common law doctrine of respondeat superior for the actions of its employee, Higgins. *Sharp v. Coopers & Lybrand*, 457 F. Supp. 879, 891 (E. D. Pa. 1978). The court also concluded as a matter of law that Coopers & Lybrand was liable for Higgins' conduct by virtue of § 20(a) of the 1934 Act, 15 U. S. C. § 78*t*(a). 457 F. Supp. at 893-94.

A second jury trial on the issue of damages sustained by the three named plaintiffs was held from May 12 through May 19, 1980. This jury found, also by special

3. Sharp also alleged common law fraud and breach of the common law duty of due care. Although the jury found Coopers & Lybrand negligent in writing and issuing the second opinion letter, it also found that the injury to the class was not foreseeable to Coopers & Lybrand. The district court denied motions by both sides for judgment, reasoning that the impact of these factual determinations on individual class members would have to be made on an individual basis with reference to the proper state law. 457 F. Supp. at 886. These issues are not now before us.

interrogatories, that the three class representatives had exercised due diligence, had filed their claims within one year of the date on which the fraud reasonably could have been discovered, and would not have invested in the partnerships absent the opinion letter. The jury also found that the "actual value" of a one-eighth limited partnership share in 1971 was $1,240.00. Based on these findings, the trial judge entered judgment in favor of Stanley L. Sharp in the amount of $6,885, Sam Geftic in the amount of $3,442.50, and H. James Conaway, Jr., in the amount of $6,193. Each representative also received prejudgment interest at the rate of six percent from December 31, 1971.

II.

In this appeal, Coopers & Lybrand advances four principal arguments.[4] First, it argues that the trial judge erred in concluding after the first trial that Coopers & Lybrand was secondarily liable for the acts of its employee, Herman Higgins, under the common law doctrine of respondeat superior. Second, it argues that the trial judge erred by failing to give proper jury instructions on § 20(a) of the 1934 Act. Third, it argues that the trial court erred during the second trial in creating a presumption that the class representative relied on the misrepresentations and omissions of the second opinion letter. Finally, it attacks the measure of damages used by the district court in the second trial.

III.

Appellant's primary argument is that it may not be held liable for the actions of Higgins in light of the jury's finding, in answer to a special interrogatory, that no Coopers & Lybrand partner possessed the necessary scien-

4. A litany of less substantial arguments is considered in part VII, *infra*.

ter to violate rule 10b-5. *See Ernst & Ernst v. Hochfelder*, 425 U. S. 185, 201-11 (1976). The trial court rejected this argument, holding as a matter of law that Coopers & Lybrand was liable for the securities law violations of Herman Higgins committed in the scope of his employment. The district court noted that this court has not recognized respondeat superior as a basis for establishing secondary liability under rule 10b-5, *see Rochez Brothers, Inc. v. Rhoades*, 527 F. 2d 880, 884 (3d Cir. 1975) (*Rochez II*), *cert. denied*, 425 U. S. 993 (1976), but reasoned that this case presents a sufficiently egregious situation to distinguish it from the prevailing case law. It relied on a "broker-dealer" exception alluded to in *Rochez II*, *id.* at 886, reasoning that an accounting firm issuing a tax opinion letter to be used in selling securities is laden with the same public trust as a broker-dealer. 457 F. Supp. at 891.

As an alternative basis for imposing liability on Coopers & Lybrand, the district court relied on § 20(a) of the 1934 Act. The district court declined appellant's invitation to instruct the jury to determine whether Coopers & Lybrand had "culpably participated" in the securities law violations. *See Rochez II*, 527 F. 2d at 884-85. The court reasoned that an adequate instruction on culpable participation would have been difficult to construct, that the facts regarding the issue were not in dispute, and that the proper manner of resolving the issue was by the court as a matter of law. 457 F. Supp. at 893.

A.

The starting point in this court for analysis of secondary liability under rule 10b-5 is *Rochez II*. In that case we held that material omissions in violation of rule 10b-5 by a purchaser serving as Chairman of the Board of Directors, Chief Executive Officer, and President of a

corporation, to the seller of a substantial block of stock in the corporation, could not be attributed to the corporation involved under principles of respondeat superior. *Rochez II*, 527 F. 2d at 885-86; *see also Rochez Brothers, Inc. v. Rhoades*, 491 F. 2d 402, 405-06 (3d Cir. 1974) (*Rochez I*). The court examined § 20(a), which imposes liability on certain controlling persons, and concluded that imposition of respondeat superior liability would circumvent the good faith defense provided in that section. 527 F. 2d at 885. The court noted:

> If we were to apply *respondeat superior* as appellant wishes, we would in essence impose a duty on a corporation to supervise and oversee the activities of its directors and employees when they are dealing with their own corporate stock as individuals, and not for the corporation or for the benefit of the corporation. To impose such a duty would make the corporation primarily liable for any security law violation by any officer or employee of the corporation. We believe that Congress did not intend to expand liability to this degree when it passed the Securities Exchange Act.

Id. Later, in *Gould v. American-Hawaiian Steamship Co.*, 535 F. 2d 761, 779 (3d Cir. 1976), the court declined to impose secondary liability on two corporations, the joint director of which had failed to disclose a conflict of interest in a proxy statement issued prior to a merger. In doing so, the court stated that "[t]he liability of Litton and Monroe for the acts of Casey . . . cannot be upheld on the agency theory utilized by the district court." *Id.* at 779. This statement operates as an explicit reaffirmation of *Rochez II*.

Relying on *Rochez II* and *Gould*, Coopers & Lybrand argues that the district court erred by imposing second-

ary liability on it under a respondeat superior theory. The Securities and Exchange Commission, as amicus curiae, argues that *Rochez II* should be narrowly construed to allow the use of respondeat superior in private damage actions under rule 10b-5, or alternatively should be overruled.[5] Appellees, although suggesting that *Rochez II* is no longer viable, propose a less drastic course of retaining the general prohibition against the use of respondeat

5. The SEC argues that "[t]he prevailing view among the federal courts" is that agency principles are applicable to impute securities law violations to employers. Brief for SEC, Amicus Curiae, at 19 (citing in n. 29, *Marbury Management, Inc. v. Kohn*, 629 F. 2d 705 (2d Cir.), *cert. denied*, 49 U. S. L. W. 3405 (Dec. 2, 1980); *Securities and Exchange Commission v. Management Dynamics, Inc.*, 515 F. 2d 801, 812-813 (2d Cir. 1975); *John Hopkins University v. Hutton*, 422 F. 2d 1124, 1130 (4th Cir. 1970), *cert. denied*, 416 U. S. 916 (1974); *Carras v. Burns*, 516 F. 2d 251, 259, 261 (4th Cir. 1975); *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F. 2d 1111, 1118-19 (5th Cir. 1980); *Lewis v. Walston & Co.*, 487 F. 2d 617, 623 (5th Cir. 1973); *Holloway v. Howerdd*, 536 F. 2d 690, 694-695 (6th Cir. 1976); *Armstrong, Jones & Co. v. Securities and Exchange Commission*, 421 F. 2d 359, 362 (6th Cir.), *cert. denied*, 398 U. S. 958 (1970); *Fey v. Walston & Co.*, 493 F. 2d 1036, 1052 (7th Cir. 1974); *Carroll v. First National Bank of Lincolnwood*, 413 F. 2d 353, 358 (7th Cir. 1969), *cert. denied*, 396 U. S. 1003 (1970); *Kerbs v. Fall River Industries, Inc.*, 502 F. 2d 731, 741 (10th Cir. 1974).

It argues further that, read narrowly, our decisions on secondary liability are not inconsistent with the general applicability of respondeat superior, but merely establish exceptions to it. Brief for the SEC at 22-23. Although our disposition of this appeal makes resolution of these issues unnecessary, we do note that as a panel of this court we are not authorized to overrule the decision of a prior panel, United States Court of Appeals for the Third Circuit. Internal Operating Procedures VIII, C, and the active judges on this panel do not request rehearing in banc. We specifically examine the decisions of other circuits at notes 6-11, *infra*, and accompanying text. The Supreme Court has not addressed this question.

superior in rule 10b-5 actions while adopting an exception for accounting firms that render investment-oriented opinion letters. We conclude that the rule announced in *Rochez II* is and should be viable, that *Rochez II* envisioned exceptions to that rule, and that this record supports the district court's determination that Coopers & Lybrand is liable for the wrongful acts of Higgins under the precise exceptions set forth therein.

B.

Our examination of the case law regarding employer liability under rule 10b-5 discloses that other courts have emphasized the special duties that certain employers assume under the federal securities laws when their conduct is likely to exert strong influence on important investment decisions. For example, the second circuit has recently relied on respondeat superior to impose liability on a brokerage house for the fraudulent conduct of a trainee in its employ. *Marbury Management, Inc. v. Kohn*, 629 F. 2d 705 (2d Cir.), *cert. denied*, 49 U. S. L. W. 3405 (Dec. 2, 1980). In holding that the plaintiff could not recover from the employer, the district court found that the employer had exercised due care in its supervision of the employee. The second circuit reversed the judgment in favor of the employer and remanded for a new trial, adopting principles of respondeat superior in this limited context. *Id.* at 716. Prior second circuit decisions had expressly declined to apply respondeat superior in other contexts,[6] however, and the only distinction be-

6. The court examined its prior holdings in *SEC v. Management Dynamics, Inc.*, 515 F. 2d 801, 811-13 (2d Cir. 1975), and *SEC v. Geon Industries, Inc.*, 531 F. 2d 39, 53-56 (2d Cir. 1976). In *Management Dynamics*, the vice president in charge of trading at A. J. Carno, Inc., a brokerage firm, submitted fictitious quotations on Management Dynamics stock on firm stationery. In affirming the injunction against the firm, the court stated:

tween those decisions and *Marbury Management* seems to be the court's conclusion that a brokerage firm owes a higher duty to its customers than do other employers.[7] The implicit reasoning in *Marbury Management*—that brokers have a higher public duty under the securities laws than do other persons—leads to imposition of a duty to exercise a high standard of supervision. This duty is enforceable through imposition of secondary liability based on respondeat superior.

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6. (Cont'd.)

> The apparent authority exercised by Nadino makes it appropriate to enjoin Carno from violation of the antifraud provisions. We stress again, however, that we intimate no view as to other cases which may involve lesser employees, actions for damages, other agency principles, *or respondeat superior, which may be broader than the apparent authority involved here.* Such cases may involve entirely different policy considerations that are best consigned to future resolution.

515 F. 2d at 813 (footnote omitted) (emphasis added). In *Geon Industries*, the court emphasized the trial court's finding that the brokerage firm had exercised reasonable supervision over the employee. 531 F. 2d at 53, 54. It refused to invoke respondeat superior on the basis of *Management Dynamics*, reasoning that the high status of the offending employee in *Management Dynamics*, and the apparent authority he exercised, were material factual distinctions. *Id.* at 55. It concluded that "[h]ere, we have only a registered representative, making no special use of his connection with his firm, and with no profit other than ordinary commissions going to it." *Id.* Although noting that the brokerage firm may have been guilty of inadequate supervision, the *Marbury Management* court noted that the failure to supervise was not sufficiently egregious to meet the scienter standard of *Ernst & Ernst*. Instead, it relied on respondeat superior as the basis for remanding the case for trial. 629 F. 2d at 712, 716.

7. "[T]here is no warrant for believing that Section 20(a) was intended to narrow the remedies of the customers of brokerage houses or to create a novel defense in cases otherwise governed by traditional agency principles." 629 F. 2d at 716.

Other courts of appeals that have employed respondeat superior have done so in cases in which the employee was a high level officer or director of the employer,[8] the employer was a brokerage firm,[9] or both.[10] In many of these decisions, the courts have emphasized

8. *See Holmes v. Bateson*, 583 F. 2d 542, 560-61 (1st Cir. 1978) (two of four former partners of a recently incorporated partnership); *Kerbs v. Fall River Indus.*, 502 F. 2d 731, 740-41 (10th Cir. 1974) (president); *Carrol v. First Nat'l Bank*, 413 F. 2d 353, 355, 358 (7th Cir. 1969) (five of 23 defendants were officers or directors of the Bank), *cert. denied*, 396 U. S. 1003 (1970). We note that high ranking officers in a corporation, or partners in a partnership, present a different situation from lower level employees. Officers are able to make policy and generally carry authority to bind the corporation. Their action in behalf of the corporation is therefore primary, and holding a corporation liable for their actions does not require respondeat superior. The first circuit apparently recognized this precept, stating in *Holmes* that the corporation "cannot escape its primary liability to the party defrauded." 583 F. 2d at 561.

9. *See Henricksen v. Henricksen*, Nos. 80-1488, 80-1584, slip op. at 15 (7th Cir., Feb. 6, 1981); *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F. 2d 1111, 1118-19 (5th Cir. 1980); *Holloway v. Howerdd*, 536 F. 2d 690, 695-96 (6th Cir. 1976); *Carras v. Burns*, 516 F. 2d 251, 259, 260-61 (4th Cir. 1975); *Lewis v. Walston & Co.*, 487 F. 2d 617, 623 (5th Cir. 1973); *Armstrong, Jones & Co. v. SEC*, 421 F. 2d 359, 361-62 (6th Cir.), *cert. denied*, 398 U. S. 958 (1970).

10. *A. J. White & Co. v. SEC*, 556 F. 2d 619, 624 (1st Cir.) (president and underwriting manager), *cert. denied*, 434 U. S. 969 (1977); *Fey v. Walston & Co.*, 493 F. 2d 1036, 1053 (7th Cir. 1974) (officer, registered representative); *SEC v. First Securities Co.*, 463 F. 2d 981, 985-86 (7th Cir.) (president, owner of 92% of stock), *cert. denied sub nom., Mcky v. Hochfelder*, 409 U. S. 880 (1972); *Johns Hopkins University v. Hutton*, 297 F. Supp. 1165, 1212-13 (D. Md. 1968) (manager of oil and gas department), *aff'd in part, rev'd in part*, 422 F. 2d 1124 (4th Cir. 1970), *cert. denied*, 416 U. S. 916 (1974).

the public trust of the firms involved, and the duty to supervise arising therefrom.[11] These decisions are consistent with our decision here. We draw support from them for our conclusion but emphasize strongly that the doctrine of respondeat superior, though applicable in this case, has not been and should not be widely expanded in the area of federal securities regulation. *See Rochez II*, 527 F. 2d at 885.

Aaron v. SEC, 446 U. S. 680 (1980), decided soon after *Marbury Management*, does not compel a different result. In *Aaron*, the Court reversed the second circuit's decision holding that the SEC need prove only negligence to obtain an injunction for violations of rule 10b-5. Aaron, a management employee at a brokerage firm, had been informed that two employees under his supervision were making gross misrepresentations in their sales of a particular security. Aaron did nothing about the complaint other than inform one of the employees about it and direct him to contact the complainant. The fraudulent conduct continued. The district court held that Aaron had "intentionally failed to discharge his supervisory responsibility," and issued an injunction. The second circuit

11. For example, the fifth circuit has recently applied respondeat superior to a broker-dealer firm, stating:

> At least with respect to the initial choice of a broker, most investors rely upon the reputation and prestige of the brokerage firm rather than the individual employees with whom they might deal. Such firms should be held accountable if employees they select utilize the firm's prestige to practice fraud upon the investing public.

Paul F. Newton & Co. v. Texas Commerce Bank, 630 F. 2d at 1119. Similarly, the sixth circuit has emphasized that the broker-dealer has "an affirmative obligation to prevent use of the prestige of its firm to defraud the investing public." *Holloway v. Howerdd*, 536 F. 2d 690, 696 (6th Cir. 1976); *Henricksen v. Henricksen*, Nos. 80-1488, 80-1584, slip op. at 15 (7th Cir., Feb. 6, 1981).

affirmed, holding that Aaron had acted negligently in supervising the two employees, and declining to reach the question whether the record supported a finding of scienter. The Supreme Court reversed, holding that the SEC, like private litigants, must prove scienter as an element when it sues for an injunction under § 10(b) and rule 10b-5. In *Aaron*, the Court dealt with a supervisory employee rather than an employer, and this distinction is important for purposes of applying respondeat superior. *See SEC v. Coffey*, 493 F. 2d 1304, 1315 (6th Cir. 1974), *cert. denied*, 420 U. S. 908 (1975). We conclude that *Aaron* does not foreclose imposition of secondary liability in the situation before us. We now address the adjudicative facts upon which the decision in this case turns.

C.

Here, two opinion letters were issued by Coopers & Lybrand. The first went out on July 21, 1971, to WMC and was signed in the firm name by a partner. The letter was in response to a request by WMC in behalf of *one* of its investors. The second letter went out in October, 1971, after knowledge by a partner, Wright, that WMC was showing copies of the letter to investors generally as part of WMC's sales program. With full knowledge of the letter's intended use — a tool to be used by a securities seller as part of a sales program — the partnership, through a partner, made the calculated decision to send out a more complete letter. Moreover, it was also decided that the letter be signed, not in the name of a partner, but in the partnership name. These facts are central to the important inquiry, whether this activity propelled Coopers & Lybrand into a position in which the investing public would place their trust and confidence in it. We determine that it did ascend to that position, and the ultimate issue turns on this determination.

In *United States v. Chiarella*, 445 U. S. 222 (1980), the Supreme Court emphasized that the petitioner, a printer who had abused inside information obtained from financial statements delivered to him for printing, "had no prior dealings with [the investors]. He was not their agent, he was not a fiduciary, he was not a person in whom the [investors] had placed their trust and confidence." *Id.* at 232. By contrast here, a realization, even an expectation, by Coopers & Lybrand that buyers of partnership interests would "place[] their trust and confidence" in the information provided them required appellant to exercise a high degree of care in preparation of the letter, and this care included close supervision of its employee, Higgins. We recognized in *Rochez II* that situations can arise in which corporations owe a duty of careful supervision to the public:

> We recognize that corporations do have certain duties imposed on them for protection of public interest. To exact this duty on a mere showing of a principal-agent relationship would violate the legislative purpose and effectively nullify the "controlling person" provision of the Act. See also *Lanza v. Drexel & Co.*, 479 F. 2d [1277, 1299 (2d Cir. 1973) (in banc)].
>
> We are not faced with the type of relationship that prevails in the broker-dealer cases where a stringent duty to supervise employees does exist. This duty is imposed to protect the investing public and make brokers aware of the special responsibility they owe to their customers. We can find no reason to impose this same duty in a situation like the one presently before us where the parties were dealing for themselves and for their own accounts.

527 F. 2d at 885-86 (footnotes omitted). In this situation, the absence of actual knowledge of or reckless disregard for material omissions or misrepresentations should not insulate Coopers & Lybrand from liability because the expectation that investment decisions would be made on the basis of the opinion letter required the firm to exercise a "stringent duty to supervise" its employees in drafting and issuing the letter. Under the circumstances of this case, viz, the existence of actual knowledge that the firm's letter would influence the investing public, we cannot distinguish the responsibility of the accounting firm here from the broker-dealer discussed in *Rochez II*.

A simple garden variety master-servant relationship is not what activates the doctrine of respondeat superior in this case. Rather, the presence of what we described in *Rochez II* as a "stringent" or high duty to supervise employees triggers the doctrine. At common law, the misrepresentations of an employee, even those made fraudulently without the employer's knowledge, will render any employer liable for damages to persons experiencing harm as a result. Restatement (Second) of Agency § 249; *id.*, comment c; § 257; § 261; § 264. Our decision does not go so far.

When the firm's public representations are designed to influence the investing public, the firm should not be shielded from compensating persons who suffered from reckless or knowing acts by its employees. Otherwise, it could immunize itself from liability by constructing a "Chinese wall" between its employees and partners, allowing only the former to draft opinion letters. Partners, with their greater experience and knowledge, would have a strong incentive to avoid using their expertise to benefit the investors to whom opinion letters are directed. *See Johns Hopkins University v. Hutton*, 297 F. Supp. 1165, 1213 (D. Md. 1968), *aff'd in part, rev'd in part*, 422 F. 2d 1124 (4th Cir. 1970), *cert. denied*, 416 U. S.

916 (1974). This incentive can be reversed only by recognizing an absolute duty on the part of the firm, which acts through its partners, to supervise employees closely whenever its representations are designed to influence the investing public. Protection of investors is, after all, the primary purpose of the securities laws. *Ernst & Ernst*, 425 U. S. at 195.[12]

D.

We recognize that accounting firms perform a valuable service in evaluating, synthesizing, and explicating complex financial data. In recognition of these important services, we emphasize the limited scope of our holding. *See Ernst & Ernst*, 425 U. S. at 216 n. 33 (expressing reluctance to "extend to new frontiers the 'hazards' of rendering expert advice" under the 1934 Act). Coopers & Lybrand contracted to draft and issue an opinion letter with notice that it would be used to influence the decisions of investors. In this limited situation, the accounting firm owes a responsibility to the investing public to exercise stringent or high supervision of its employees, and failure to perform this duty will expose it to liability for their violations of rule 10b-5 under the doctrine of respondeat superior.

12. Interrogatory number 11 asked the jury: "Was it foreseeable to the defendant that purchasers of Westland Securities would be likely to suffer injury or damages as a result of misrepresentations in the opinion letter of" October 11, 1971. The jury replied in the negative. App. at 1650a. This interrogatory means only that Coopers & Lybrand, ignorant as it was of the misrepresentations and omissions propounded by Higgins, could not reasonably foresee that readers would be *defrauded*. It is not inconsistent with our analysis that Coopers & Lybrand could foresee widespread use of the letter as part of the securities selling program; nor is it inconsistent with our holding that, under the circumstances of this case, Coopers & Lybrand assumed an absolute duty to supervise its employees.

IV.

The trial court also held Coopers & Lybrand liable for the acts of Higgins under § 20(a) of the 1934 Act:

> Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action.

15 U. S. C. § 78t(a). We have previously interpreted this section as imposing "secondary liability on one who controls a violator of the securities laws, and who fails to show he acted in 'good faith.'" *Rochez II*, 527 F. 2d at 889. One element of any case imposing liability under § 20(a) is "culpable participation" in the securities violation. *Id.* at 885.[13] To impose secondary liability on a controlling person for his inaction, the plaintiff must prove that the inaction "was deliberate and done intentionally to further the fraud." *Id.* at 890.

In this case, the trial judge declined to give a jury instruction on "culpable participation," instead resolving the issue himself as a matter of law. 457 F. Supp. at 893. The court relied on our decision in *Straub v. Vaisman & Co.*, 540 F. 2d 591 (3d Cir. 1976), in which we affirmed a trial judge's findings of fact and conclusions of law hold-

13. Other circuits appear to agree with our construction of § 20(a). *See, e.g., Zweig v. Hearst Corp.*, 521 F. 2d 1129, 1135 (9th Cir. 1975), *cert. denied*, 423 U. S. 1025 (1975); *Gordon v. Burr*, 506 F. 2d 1080, 1085 (2d Cir. 1974); *Lanza v. Drexel & Co.*, 479 F. 2d 1277, 1299 (2d Cir. 1973) (in banc).

ing a securities brokerage firm liable for the fraudulent acts of an employee. We there stated that "[t]he company's active participation in the scheme, its receipt of the benefits and its status as a broker-dealer fully justify imposition of liability. It is clear that VaisCo's role was not merely that of a facade for fraud, but rather one of a culpable confederate." *Id.* at 596 (citing *Rochez II*).

The procedural context of *Straub*, as compared to the present appeal, is significant. *Straub* was an appeal from a bench trial in which the judge had found sufficient facts to meet the test of "culpable participation." In contrast, this case arises from a jury trial, and even though the trial judge found culpable participation, he invaded the province of the jury by doing so. The proper arbiter of this factual dispute was the jury. We hold that the trial court erred in failing to instruct the jury in accordance with the law of this court.

Although we find error, it does not require retrial of the liability issue. The preceding analysis imposing a duty of careful supervision on Coopers & Lybrand, enforceable through respondeat superior, adequately justifies affirming the district court's determination that Coopers & Lybrand was liable. The error occasioned by improper application of § 20(a) is therefore harmless.

V.

Appellant next argues that the trial judge erred in his instruction to the jury on reliance and in formulating the special interrogatory to the jury on that issue. The trial judge instructed the jury that the appellees were entitled to a rebuttable presumption of reliance.[14] In the

14. In his instruction to the jury on reliance, the trial judge said:

> In a case of this type it must be found that the plaintiff . . . relied on the misrepresentations or was influenced to the point of purchasing by the omission. . . .

special interrogatories to the jury regarding reliance, the trial court asked with respect to each named plaintiff: "Would [the plaintiff] have purchased his investment in the 1971 WMC Ohio Program . . . even if the truth had been told in defendant's opinion letter?" App. at 2814a. The jury answered in the negative with regard to each class representative. Appellant argues first that the court erred in creating a presumption of reliance favoring the appellees, and second that the effect of the interrogatory was to create an irrebuttable presumption of reliance. We conclude that in the circumstances presented by this case, which involves both misrepresentations and omissions, the district court correctly allowed a presumption of reliance. In addition, we find no support for appellant's assertion that the trial court employed an irrebuttable presumption. We therefore reject both arguments.

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14. (Cont'd.)

> In this respect the plaintiffs are entitled to a presumption of reliance. . . . By a presumption we mean that a given fact is established by the establishment of certain other facts, thus putting upon the other side the duty to persuade you to the contrary.
>
> In this case where there are material omissions and where there are material omissions mingled with misrepresentations, the plaintiffs are presumed to rely upon the contents of that letter. Of course, the bottom line was that there would be a double tax deduction, but the others, the omissions in particular are woven in to that conclusion that there would be a double tax deduction, when in fact of course there was not.
>
> When there is a presumption as there is here in that respect the defendant has the burden of going forward and persuading you by a fair preponderance of the evidence that the plaintiffs would have purchased the securities at the same price even had they known there was no double tax deduction; even had they known there would not be a bona fide loan; even had they known the other omissions that were in the letter. This is the defendant's burden.

App. at 2682a-83a.

A.

Reliance is an element of a plaintiff's action for damages under rule 10b-5. *See Straub v. Vaisman & Co.*, 540 F. 2d at 596; *Landy v. FDIC*, 486 F. 2d 139, 170 (3d Cir. 1973), *cert. denied*, 416 U. S. 960 (1974); *see also Thomas v. Duralite Co.*, 524 F. 2d 577, 583 (3d Cir. 1975).[15] The obvious reason for this requirement is that a plaintiff in a rule 10b-5 action should not be allowed to recover damages when the defendant's wrongful action had no relationship to the plaintiff's loss. *See* 3 A. Bromberg, Securities Law § 8.7, at 213 (1979). Reliance is therefore one aspect of the ubiquitous requirement that losses be causally related to the defendant's wrongful acts. *Rochez I*, 491 F. 2d at 410; *see* Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 Harv. L. Rev. 584, 587 (1975); *see also* Prosser, The Law of Torts § 41, at 236 (4th ed. 1971).[16] This precept is

15. In *Kohn v. American Metal Climex, Inc.*, 458 F. 2d 255, 269 (3d Cir.), *cert. denied*, 409 U. S. 874 (1972), we stated that "those alleging a violation of Rule 10b-5 have an obligation to show a fraudulent and material misrepresentation and that, to the extent a reliance factor is required, in the present context it is encompassed by the finding that the misrepresentation was material." Similarly, in *Kahan v. Rosenstiel*, 424 F. 2d 161, 173 (3d Cir.), *cert. denied*, 398 U. S. 950 (1970), we stated that "[p]roof of reliance is not an independent element which must be alleged to establish a cause of action." Both *Kohn* and *Kahan* were actions arising out of proxy statements issued during corporate combinations. Such cases present unique problems of demonstrating reliance not applicable to the present case. *See Mills v. Electric Auto-Lite Co.*, 396 U. S. 375, 384-85 (1970). We also note that the "purchaser-seller" rule of *Blue Chip Stamps v. Manor Drug Stores*, 421 U. S. 723 (1975), would now preclude the *Kahan* suit, *see* 424 F. 2d at 173, thereby circumventing major reliance-causation problems in that context.

16. The fifth circuit has recently noted that proof of reliance is necessary but not sufficient to establish causation:

manifest in the Securities Exchange Act of 1934 in § 28(a), 15 U. S. C. § 78bb(a), which states in part that "no person permitted to maintain a suit for damages under the provisions of this chapter shall recover, through satisfaction of judgment in one or more actions, a total amount in excess of his actual damages on account of the act complained of." Normally, a plaintiff suing under rule 10b-5 bears the burden of proving all the elements of his case. *See McLean v. Alexander,* 599 F. 2d 1190, 1196-97 (3d Cir. 1979). Nevertheless, the necessity of an element to a valid claim does not determine the allocation of the burdens of going forward and persuasion with respect to that element. *See* McCormick's Handbook of the Law of Evidence § 337, at 785-86 (Cleary ed. 1972).

The Supreme Court authoritatively addressed the requirement of proving reliance in rule 10b-5 actions in *Affiliated Ute Citizens of Utah v. United States,* 406 U. S. 128 (1972), stating:

> Under the circumstances of this case, involving primarily a failure to disclose, positive proof of reliance is not a prerequisite to recovery. All that is necessary is that the facts withheld be material in the

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16. (Cont'd.)

> The causation requirement is satisfied in a Rule 10b-5 case only if the misrepresentation touches upon the reasons for the investment's decline in value. If the investment decision is induced by misstatements or omissions that are material and that were relied on by the claimant, but are not the proximate reason for his pecuniary loss, recovery under the Rule is not permitted.

Huddleston v. Herman & MacLean, No. 79-3712, slip op. at 27 (5th Cir. Unit A, March 9, 1981). *See also Schlick v. Penn-Dixie Cement Corp.,* 507 F. 2d 374, 380-81 (2d Cir. 1974), *cert. denied,* 421 U. S. 976 (1975). *Schlick* employed the terms "transaction causation" (reliance) and "loss causation" to define the distinct concepts in a rule 10b-5 action.

> sense that a reasonable investor might have considered them important in the making of this decision. This obligation to disclose and this withholding of a material fact establish the requisite element of causation in fact.

Id. at 153-54 (citations omitted). The Court has subsequently defined a material omission in the context of proxy statements under rule 14a-9 as "a substantial likelihood that a reasonable [investor] would consider it important . . . . [T]here must be a substantial likelihood that the disclosure of the omitted fact would have been viewed by the reasonable investor as having significantly altered the 'total mix' of information made available." *TSC Industries, Inc. v. Northway, Inc.*, 426 U. S. 438, 449 (1976). We have held this standard of materiality applicable to rule 10b-5 actions as well. *See Healey v. Catalyst Recovery of Pennsylvania, Inc.*, 616 F. 2d 641, 647 (3d Cir. 1980); *id.* at 653 (Aldisert, J., dissenting).[17] *Affiliated Ute* makes clear that in at least some situations a presumption of reliance in favor of the rule 10b-5 plaintiff is proper. *See Rochez I*, 491 F. 2d at 410. Our present task is to determine whether that presumption was properly applied in this case.

Both parties in this case cite decisions indicating that the presumption of reliance is proper in cases of alleged omissions, whereas no presumption arises in cases of al-

17. Other circuits have reached the same conclusion. *See, e.g., Steadman v. SEC*, 603 F. 2d 1126, 1130 (5th Cir. 1979), *cert. denied*, 446 U. S. 917 (1980); *Goldberg v. Meridor*, 567 F. 2d 209, 218-19 (2d Cir. 1977), *cert. denied*, 434 U. S. 1069 (1978); *Alton Box Board Co. v. Goldman, Sachs & Co.*, 560 F. 2d 916, 919-20 (8th Cir. 1977); *Wright v. Heizer Corp.*, 560 F. 2d 236, 247-48 (7th Cir. 1977), *cert. denied*, 434 U. S. 1066 (1978); *Woolf v. S. D. Cohn & Co.*, 546 F. 2d 1252, 1253 (5th Cir.) (per curiam), *cert. denied*, 434 U. S. 831 (1977).

leged misrepresentations. *See, e.g., Vervaecke v. Chiles, Heider & Co.*, 578 F. 2d 713, 717-18 (8th Cir. 1978); *Rifkin v. Crow*, 574 F. 2d 256, 262-63 (5th Cir. 1978); *Schlick v. Penn-Dixie Cement Corp.*, 507 F. 2d 374, 380-81 (2d Cir. 1974), *cert. denied*, 421 U. S. 976 (1975). This distinction has led Coopers & Lybrand to argue that its wrongful conduct in this case arose from misrepresentations in the opinion letter, whereas the class representatives argue that the violation resulted from the appellant's failure to disclose certain material facts.

We have concluded that both misrepresentations and omissions are present in this case. The jury heard evidence that Coopers & Lybrand had misrepresented certain crucial facts in the letter, such as its disclaimer of verification of the facts on which the opinion letter was based and its assertion that cash supplemental to the limited partner's contributions would be borrowed "from suitable banks or other lending agencies . . . ." App. at 2892a, 2894a. The jury also heard evidence that Coopers & Lybrand had failed to disclose certain material facts, such as the affiliation between the putative lender, the Bahamian bank, and WMC. App. at 1202a, 938-39a. A strict application of the omissions-misrepresentations dichotomy would require the trial judge to instruct the jury to presume reliance with regard to the omitted facts, and not to presume reliance with regard to the misrepresented facts. Although this resolution would have great appeal to graduate logicians in a classroom, we are not persuaded to adopt it for use in a courtroom.

B.

We begin by embracing the obvious proposition recently stated by the second circuit: "We therefore presume reliance only 'where it is logical' to do so." *Lewis v. McGraw*, 619 F. 2d 192, 195 (2d Cir. 1980) (action un-

der § 14(e) of the Williams Act, 15 U. S. C. § 78n(e)), *cert. denied*, 49 U. S. L. W. 3332 (Nov. 4, 1980). A steadfast rule requiring the defendant to refute a presumption of reliance would be neither equitable nor logical. The plaintiff traditionally assumes the burden of demonstrating causation. *See Eriksson v. Galvin*, 484 F. Supp. 1108, 1126 (S. D. N. Y. 1980); *see also* 3 A. Bromberg, Securities Law § 8.7, at 213 (1979); Prosser, Handbook of the Law of Torts § 41, at 241 (4th ed. 1971); *but see Collins v. Signetics Corp.*, 605 F. 2d 110, 114 (3d Cir. 1979) (§ 11(a) of the 1933 Act, 15 U. S. C. § 77(e), shifts burden on causation to defendant). Only in unusual circumstances is this burden shifted from the plaintiff to the defendant. The reason for shifting the burden on the reliance issue has been an assumption that the plaintiff is generally incapable of proving that he relied on a material omission. *Lewis v. McGraw*, 619 F. 2d at 195; *Thomas v. Duralite Co.*, 524 F. 2d at 585.[18] This incapacity arises from the difficulty of proving a speculative state of facts: Had the facts not been omitted, would plaintiff have acted on the information made available and thereby averted his loss? But this observation does not justify a clear distinction between the treatment of misrepresentations and omissions. First, the defendant

18. One commentator has reasoned that "[s]ince nothing is affirmatively represented in a nondisclosure case, demanding proof of reliance would require the plaintiff to demonstrate that he had in mind the converse of the omitted facts, which would be virtually impossible to demonstrate in most cases." Note, *The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 Harv. L. Rev. 584, 590 (1975) (footnote omitted). *See also Vervaecke v. Chiles, Heider & Co.*, 578 F. 2d 713, 717-18 (8th Cir. 1978); *Titan Group, Inc. v. Faggen*, 513 F. 2d 234, 239 (2d Cir.), *cert. denied*, 423 U. S. 840 (1975). A discussion of the reasons for creating presumptions generally appears in McCormick's Handbook of the Law of Evidence § 343, at 806-07 (Cleary ed. 1972).

confronts the same problem of speculation in trying to refute the presumption of reliance because he possesses no more information on the plaintiff's hypothetical behavior than does the plaintiff. Second, the problem of speculation is not unique to situations in which omissions have occurred. In misrepresentation actions as well, proof of reliance requires a degree of speculation on the action that the plaintiff would have taken had no misrepresentation occurred. Therefore, we are unpersuaded that the existence of misrepresentations *and* omissions, without more, necessitates any particular treatment of the reliance issue.

A further consideration guides our decision. If we were to follow blindly the omission-misrepresentation distinction in this case, we would be compelled to require a dual jury instruction. The jury would be instructed to search for proof of reliance by the plaintiff with regard to the misrepresentations, and to search for proof of nonreliance by the defendant with regard to the omissions. The problems with such a complicated approach before a lay jury are legion. We conclude that the proper approach to the problem of reliance is to analyze the plaintiff's allegations, in light of the likely proof at trial, and determine the most reasonable placement of the burden of proof of reliance. *See Affiliated Ute*, 406 U. S. at 153-54 ("positive proof of reliance" not required *"under the circumstances of this case"*) (emphasis added). Such a flexible approach avoids the potential problems of a broad judicial pronouncement of a precept governing reliance.[19]

19. In *Huddleston v. Herman & McLean*, No. 79-3712 (5th Cir. Unit A, March 9, 1981), the fifth circuit held that reliance will be presumed for omissions falling within the first or third paragraphs of rule 10b-5, but will not be presumed for misrepresentations or omissions falling within the second paragraph of rule 10b-5.

We agree with the district court that the burden in this case should fall on Coopers & Lybrand. The opinion letter issued by Coopers & Lybrand was intended to influence the investment decisions of persons interested in WMC partnerships. The appellant undoubtedly foresaw that it would have that effect.[20] As in *Affiliated Ute*, Coopers & Lybrand by its action facilitated the transactions at issue but failed to disclose certain facts. Its misrepresentation of other facts should not alleviate its burden of proving nonreliance. Considering the likelihood that investors would rely on the opinion letter, we conclude that the trial judge properly placed the burden of refuting a presumption of reliance on the appellant.

C.

Although we agree with appellant that the presumption of reliance, when appropriate, is rebuttable, *see Thomas v. Duralite Co.*, 524 F. 2d at 585, we reject its argument that the interrogatories made the presumption

19. (Cont'd.)

This case, involving alleged misstatements and omissions in a prospectus published pursuant to a public offering, cannot properly be characterized as an omissions case of the type for which the *Affiliated Ute* presumption was fashioned. The defendants did not "stand mute" in the face of a duty to disclose as did the defendants in *Affiliated Ute*, 406 U. S. at 153, 92 S. Ct. at 1472, 31 L. Ed. 2d at —. They undertook instead to disclose relevant information in an offering statement now alleged to contain certain misstatements of fact and to fail to contain other facts necessary to make the statements made, in light of the circumstances, not misleading.

Id., slip op. at 24. This attempt to inject more certainty into the allocation of the burden of reliance suffers from the difficulty of trying to pigeon-hole a particular rule 10b-5 action into only one of the three paragraphs in rule 10b-5.

20. *See* note 12, *supra*.

irrebuttable. The interrogatories on reliance did not, to be sure, emphasize this point, but if the trial judge had intended to make the presumption irrebuttable, no interrogatories on reliance would have been submitted. In addition, the jury instructions made crystal clear that the presumption was rebuttable. *See* n. 14, *supra*. We therefore find no error in the trial court's treatment of reliance.[21]

VI.

The fourth issue is the proper measure of damages. The trial judge adopted an "out-of-pocket" theory of damages, which he defined in his opinion as "the difference between the price [plaintiffs] paid for their investment and what it was actually worth at the time of purchase." *Sharp v. Coopers & Lybrand*, 83 F. R. D. 343, 347 (E. D. Pa. 1979). He explained this formulation in the jury instruction by stating:

> We are asking you to find what was the actual value of this investment in 1971. You heard Mr. Wilson testify that he would have projected in 1971 400 million cubic feet of gas and oil. . . . and that that would give a return of . . . somewhere around . . . $7900 over a nine-year period.
>
> However, when he adopted the same method of Mr. Templeton, who took the average production

21. Rule 301, Fed. R. Ev., states that "a presumption imposes on the party against whom it is directed the burden of going forward with evidence to rebut or meet the presumption, but does not shift to such party the burden of proof in the sense of the risk of nonpersuasion, which remains throughout the trial upon the party on whom it was originally cast." Appellant has not questioned the trial court's instruction as shifting both the burden of going forward and the burden of persuasion, and the issue is therefore not properly before us.

> over . . . five years, . . . he came out with 250 million cubic feet of gas and oil.
>
> I am now instructing you to disregard Mr. Wilson's testimony as to the 400 million cubic feet because the test is: *What was the actual value in 1971, not its theoretical value in 1971.*
>
> So, you will disregard that, and you will make your choice on the actual value of these investments between the testimony of Mr. Whitman who in effect said it had no value because it was not saleable and that he would not advise anybody to touch it, the testimony of Mr. Templeton who gave you a figure of $1,240, and the testimony of Mr. Wilson who gave you a figure of $4,080 for a ¼ interest but who also said that if he knew of fraud, if he knew that the General Partner was dishonest, that he wouldn't touch it with a 10-foot pole.

App. at 2691a-92a (emphasis added). The interrogatory submitted to the jury on the issue of damages asked "[w]hat was the actual value, if any, of a ¼ limited partnership interest in a 1971 WMC Ohio Producers Program as of late December, 1971?" App. at 2815a. The jury adopted Mr. Templeton's figure of $1,240. *Id.* We conclude that this formulation of damages was incorrect, and we therefore reverse and remand for a new trial on the damages issue.

A.

The Supreme Court addressed the measure of damages in rule 10b-5 actions in *Affiliated Ute*, concluding that "the correct measure of damages under § 28 of the Act, 15 U. S. C. § 78bb(a), is the difference between the fair value of all that the . . . seller received and the fair value of what he would have received had there been no

fraudulent conduct . . . ." 406 U. S. at 155 (citations omitted). To paraphrase our previous interpretation of this passage, "the measure of damages is the difference between what the [buyer paid] for his stock and what he would have [paid] had there been no fraudulent conduct." *Thomas v. Duralite Co.*, 524 F. 2d at 586. *See also Huddleston v. Herman & McLean*, No. 79-3712, slip op. at 42-43 (5th Cir. Unit A, March 9, 1981); *Glick v. Campagna*, 613 F. 2d 31, 36 (3d Cir. 1979). Appellant argues that the trial court's formulation places it in the position of insuring the appellees' investment. It argues that the proper measure of damages is the additional tax that the appellees had to pay when the IRS denied the deductions that the opinion letter forecast.

We agree with the appellant's argument in part. By requiring the jury to find the "actual value" of the investments in 1971, and by allowing them to consider subsequent production data unknown to anyone at the time the investment was made, the court neglected the speculative nature of the investment at the time the appellees bought it. Appellees found the investment attractive for two reasons. First, it offered a potential for future appreciation and income if the oil wells were successful. The nature of the petroleum exploration business necessarily renders this potential uncertain. Second, it offered an opportunity for rapid deduction of twice as much money from the investor's tax return as he actually invested. This aspect of the investment was less speculative, based as it was on the advice rendered in the October, 1971, opinion letter.

Our goal in formulating a damage instruction must be to compensate appellees precisely for the damage directly resulting from the appellant's wrongful acts. Investors viewing the oil drilling opportunities offered by WMC in 1971 might have considered the probability of a

substantial monetary return to have been great, even if they had access to all information available at that time. But by allowing the jury to consider subsequent production figures from the wells, the risk inherent in the investments when made in 1971 was removed. If the opinion letter contained omissions and misrepresentations impacting only on the validity of the tax opinion, the proper measure of damages is the amount of money invested minus the value of the speculative investment at the time of purchase, derived from all information available to the investors at the time, without considering the predicted tax benefits.[22] The record before us does not demonstrate conclusively that this formula would encompass all components of allowable recovery. Accordingly, we remand for a new trial on damages.

B.

We believe that on remand the parties should be more discriminating in advancing or defending various damage theories. Moreover, the parties should request the court to submit special interrogatories that break down the damage award more specifically than the ones used in the previous trial. Thus, if the appellees can establish at the damages retrial that Coopers & Lybrand knew, by knowledge imputed from Higgins, that the money mentioned in the opinion letter would not actually be borrowed by WMC or would not actually be invested, that is a fact that would affect the speculative value of the investment. They would be able to demonstrate that without the expenditures for drilling, the risk of no long term return was greatly increased. The proper measure of damages in this situation would be more than the tax loss; it

22. Because the figure resulting from this calculation may not equal the amount of the lost tax deduction, we reject appellant's argument that the amount of taxes subsequently collected by the IRS is the correct measure of damages.

would be the amount of money paid by each investor minus the value the investment would have had if Coopers & Lybrand had disclosed all it knew through Higgins. The subsequent returns on the investment, of course, would have to be deducted from the difference obtained. On the other hand, the investors may have been provided with the most accurate information on the oil production potential of their partnership shares. If so, subsequent events rendering that information invalid should not allow the investors to deem a party who had no connection with the investment information the effective insurer for risks that the investors knowingly took.

C.

Thus, in our view, it is central to a proper determination of damages that the evidence control the specific interrogatories to be submitted to the jury. In any event, it is important to separate concepts of possible investment loss from the possibility that the only loss sustained related to tax advantages.

VII.

Appellant also raises a number of issues that require only abbreviated consideration.

A.

The first of these issues is that the action is barred by the statute of limitations. The three named class representatives reside in different states. Sharp resides in Pennsylvania, Geftic in New Jersey, and Conaway in Delaware. At trial, the parties and the trial judge apparently assumed that the one year limitation in § 504(a) the Pennsylvania Securities Act, Pa. Stat. Ann. tit. 70, § 1504(a) (Purdon Supp. 1980), applied to this action. The appellees' theory on statute of limitations was "reasonable discovery," and they date their discovery as some-

time after May 7, 1954. Suit was filed on May 4, 1975. The jury answered the interrogatories relevant to the three individual plaintiffs favorably to the plaintiffs, and Coopers & Lybrand moved for judgment n. o. v. We do not reach appellant's argument that the jury's answer to the interrogatory on the reasonable discovery issue was against the manifest weight of the evidence. Instead, we conclude that a six year statute of limitations is applicable.

This court has recently examined the applicable statute of limitations for rule 10b-5 cases in two decisions. The first, *Roberts v. Magnetic Metals Co.*, 611 F. 2d 450 (3d Cir. 1979), held that a rule 10b-5 action arising in New Jersey would be governed by the six year statute of limitations for common law fraud rather than the statute applicable to actions under the New Jersey Uniform Securities Act. In *Biggans v. Bache Halsey Stuart Shields, Inc.*, 638 F. 2d 605 (3d Cir. 1980), we held that the six year statute of limitations for common law fraud,[23] rather than the one year limitation in § 504 of the Pennsylvania Securities Act, applied to a rule 10b-5 action for "churning" that arose in Pennsylvania. The court reasoned that the Pennsylvania securities statute grants a private remedy to a buyer only against his seller. It concluded that an action against a broker would not lie under the statute, and that the most analogous state action was an action for common law fraud. 638 F. 2d at 610.

Biggans is not distinguishable from this case. As in *Biggans*, the defendant here is not the seller, and a state securities action will not lie. The only remedy under state law would appear to be common law fraud, and the six year statute governs. Thus, Coopers & Lybrand's argument that the plaintiffs were on notice by October,

23. Pa. Stat. Ann. tit. 12, § 31 (Purdon 1953), *repealed and replaced by* Act of July 9, 1976, Act No. 142, 1976 Pa. Laws 586 (codified at 42 Pa. Cons. Stat. §§ 5521-5536 (Purdon Supp. 1980)).

1973, is irrelevant, for suit was filed well within the statutory period.[24]

B.

Coopers & Lybrand next argues that the trial judge abused his discretion in certifying a class action. It argues that hundreds of individual actions will be necessary even though the trial judge granted certification. This argument misses the point of class actions. If Coopers & Lybrand had been found not liable in the class action, all 240 potential suits would have been resolved in its favor. Since it lost that suit, the only remaining issue to be resolved on an individual basis is damages. The time savings are undeniable, and we see no abuse of discretion. *See Wetzel v. Liberty Mutual Insurance Co.*, 508 F. 2d 239, 245 (3d Cir.), *cert. denied*, 421 U. S. 1011 (1975).

C.

Appellant's attack on the district court's decision to bifurcate the trial is fully contingent on the class certification argument. If class certification were proper, sub-

24. Although the reasonable discovery rule may become important for other plaintiffs in the class, we need not discuss any of the issues that may arise in those actions. Similarly, because each party has assumed the applicability of the Pennsylvania statute of limitations, we need not address the possible relevance of the Pennsylvania "borrowing" statute, Pa. Stat. Ann. tit. 12, § 39 (Purdon 1953), *repealed and replaced by* Act of July 9, 1976, Act No. 142, 1976 Pa. Laws 586 (codified at 42 Pa. Cons. Stat. Ann. § 5521(b) (Purdon Supp. 1980)). The borrowing statute requires a court sitting in Pennsylvania to use either the Pennsylvania statute of limitations or the statute of the place where the claim accrued, whichever is shorter. Although *Roberts* and *Biggans* indicate the New Jersey and Pennsylvania would both apply the six year common law fraud statute, we will not on this record speculate, for purposes of Conaway, on the appropriate Delaware statute.

sequent trials would be required to determine the individual issues. In addition, the standard of review on this issue is abuse of discretion, *see Idzojtic v. Pennsylvania R.R. Co.*, 456 F. 2d 1228, 1230 (3d Cir. 1972), and we find none.

D.

Appellant's next argument is that the trial court erred in awarding prejudgment interest at the rate of six percent to the individual plaintiffs. It contends that the interest award reflected a double recovery because in establishing damages the plaintiff's expert discounted the losses to reflect a 1971 value. Beginning with a calculation of $10,932, Elmer Templeton applied a discount factor of eight percent "[s]o that $10,932 which the investor in a whole well would receive but in drips and drabs over a period of five years was worth at the beginning of 1972 or the middle of 1972 $9,926." App. at 2129a. Templeton then divided $9,926 by eight to obtain $1,240 as the 1971 value of a one-eighth partnership share. Application of the discount factor did *not raise* the damages claimed by plaintiffs, but *lowered* them. Subsequent application of a prejudgment interest rate, therefore, did not give plaintiffs a windfall; it merely allowed them some return on the money tied up in the partnerships.

With respect to the general standards for award of prejudgment interest, this court noted in *Gould v. American-Hawaiian Steamship Co.*, 535 F. 2d at 784-85, that the determination is to be based on fairness and is within the discretion of the district court. *See Thomas v. Duralite Co.*, 524 F. 2d at 589. Although Coopers & Lybrand is correct in arguing that it did not have the use of plaintiffs' money during the relevant time period, it is incorrect in arguing that this fact is determinative. To the extent Coopers & Lybrand was responsible for plaintiffs'

losses, the trial judge did not abuse his discretion in awarding interest against it.

E.

Coopers & Lybrand next argues that appellees failed to establish the requisite scienter, required in rule 10b-5 actions by *Ernst & Ernst*. This issue differs from the secondary liability issue in that Coopers & Lybrand is here arguing that the trial court applied an improper standard of scienter to the actions of Herman Higgins. In this circuit, the standard for scienter includes recklessness. *See Coleco Industries, Inc. v. Berman*, 567 F. 2d 569, 574 (3d Cir. 1977) (per curiam), *cert. denied*, 439 U. S. 830 (1978). *In McLean v. Alexander*, we adopted the definition of recklessness applied to rule 10b-5 actions by the seventh circuit in *Sundstrand Corp. v. Sun Chemical Corp.*, 553 F. 2d 1033, 1045 (7th Cir.), *cert. denied*, 434 U. S. 875 (1977). We stated:

> In *Sundstrand Corp. v. Sun Chemical Corp.*, . . . the Seventh Circuit stated the minimum threshold for liability under § 10(b) as follows:
>
> > "[R]eckless conduct may be defined as . . . highly unreasonable [conduct], involving not merely simple, or even inexcusable negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it."
>
> In context, the *Sundstrand* formula was applied only to omissions, but the standard of liability proposed there is, we think, equally applicable to misstatements, and we approve it in both contexts.

McLean v. Alexander, 599 F. 2d at 1197 (citation and footnote omitted). The trial judge tracked this language in his instruction to the first jury, which tried the class issues:

> Reckless conduct may be defined as a highly unreasonable statement or omission involving not merely negligence or inexcusable negligence, but an extreme departure from standards of ordinary care, presenting a danger of misleading buyers that is either known to the defendant or is so obvious that the defendant must have known of it.

App. at 1614a. In the interrogatories submitted to the first jury, he asked: "[D]o you find that Herman Higgins, acting in the scope and course of his duties as an employee of defendant, *caused with scienter, that is, intent to defraud or recklessness as I have defined it to you:* (a) the material misrepresentations; (b) the material omissions." App. at 1648a (emphasis added). The jury answered both questions "yes."

We interpret appellant's other argument on scienter to be a convoluted adjunct to its secondary liability argument. Appellant predicates the scienter argument on the jury's finding in the first trial that "it [was not] foreseeable to the defendant that purchasers of Westland Securities would be likely to suffer injury or damages as a result of misrepresentations . . . ." Referring to the definition of recklessness in *McLean*, Coopers & Lybrand argues that recklessness was not shown. It is absolutely correct, *but only if* appellees had to show that appellant acted recklessly in causing the rule 10b-5 violations. As we have concluded previously, although Coopers & Lybrand did not participate in the violations, it owed a duty of careful supervision to the investors, enforceable by the

common law doctrine of respondeat superior, and therefore it may be liable for the reckless actions of its employee.

The argument that Higgins did not possess the requisite scienter is frivolous. Coopers & Lybrand relies on a deposition taken from Higgins after he had testified before the grand jury. It concedes that many of the statements made in the deposition are inconsistent with statements made before the grand jury. *See* Appellant's Reply Brief at 6. In the deposition, Higgins attested to his own good faith and pure motives, explaining away the inconsistencies by stating that he did not have his diary present when he testified before the grand jury. A purer question of credibility has rarely been formulated, and the jury simply found Higgins' grand jury testimony more credible.

F.

Appellant's due diligence argument essentially states that the plaintiffs acted unreasonably in failing to discover the misrepresentations and omissions and that this failure should absolve it of liability. The trial judge propounded interrogatories to the jury on this issue with regard to each class representative, and the jury resolved them against appellant. App. at 2814-15. The interrogatories belie the further assertion that the trial judge improperly shifted the burden of proof on the due diligence issue to appellant.

VIII.

For the foregoing reasons, we will vacate the award of damages and remand to the district court for a new trial on that issue. The judgment of the district court in all other respects will be affirmed.

Each side to pay its own costs.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 80-2229

SHARP, STANLEY L.

v.

COOPERS & LYBRAND, *Appellant*
(E. D. Pa. Civil No. 75-01313)

Present: ALDISERT and HIGGINBOTHAM, *Circuit Judges*
and MARKEY, *Chief Judge.**

ORDER AMENDING OPINION

In the slip opinion filed April 28, 1981, the second full paragraph on page 34, lines 14 and 15, delete

> Application of the discount factor did not *raise* the damages claimed by plaintiffs, but *lowered* them.

and substitute therefor:

> Application of the discount factor was necessary to standardize the value of dollars actually invested in 1971 and the value of dollars that the investors could reasonably expect to receive in subsequent years; it was merely mathematical. In contrast, the prejudgment interest award was compensatory; it gave the plaintiffs some compensation for losing the use of the money prior to judgment.

By THE COURT,
RUGGERO J. ALDISERT
Circuit Judge

DATED: June 5, 1981

* Honorable Howard T. Markey, of the United States Court of Customs and Patent Appeals, sitting by designation.

UNITED STATES DISTRICT COURT,
E. D. PENNSYLVANIA.

Stanley L. SHARP

v.

COOPERS & LYBRAND

Civ. A. No. 75-1313

Feb. 19, 1976

JOSEPH S. LORD, III, *Chief Judge.*

This action alleges violations of section 10(b) of the Securities Exchange Act of 1934, 15 U. S. C. § 78j(b) (1970) and rule 10b-5 promulgated thereunder by the Securities and Exchange Commission. The complaint also has two pendent counts based on fraud and failure to exercise due care. Plaintiff has moved for class action certification. We will grant the motion.

Westland Minerals Corporation ("WMC") was the promoter of a venture in which multiple limited partnerships were formed whose purpose was to drill for oil and gas. WMC sold interests in each of these partnerships from July 22, 1971 through early July, 1972.

Each limited partnership was to spend $140,000 on drilling and developing a well. Of this amount, $65,000 was to be raised from contributions by investors in the partnership, the balance from "suitable banks or other lending institutions." Plaintiff purchased a ⅛ share in a partnership at a cost of $8,175. According to an affidavit filed by an SEC investigator in *SEC v. Westland Minerals Corporation,* Civil No. 72-2337 (E. D. Pa.), there were 283 investors who contributed a total of $3,472,608 to the development of some 59 oil and gas wells.

Plaintiff alleges that the primary feature of the WMC investment was its tax shelter aspect. According to plaintiff, WMC's sales promotion was based on the claim that because of favorable tax treatment, the investor was risking none of his own money.[1] As an auxiliary to its sales presentation, WMC and its salesmen used a tax opinion letter issued by defendant. The opinion letter by defendant deals with the tax treatment of certain "unverified facts" which had been supplied to Coopers & Lybrand by WMC. Plaintiff alleges that this opinion letter was materially false and misleading because of a number of omissions and misrepresentations therein.

Plaintiff seeks to represent a class of all persons "who purchased on and after July 22, 1971, limited partnership interests in a tax shelter program relating to oil and gas wells, known as the 1971 WMC Ohio Producers' Limited Partnerships."

Rule 23(a) of the Federal Rules of Civil Procedure permits maintenance of an action as a class action when:

> "(1) the class is so numerous that joinder of all members is impracticable, (2) there are questions of law or fact common to the class, (3) the claims or defenses of the representative parties are typical of the claims or defenses of the class, and (4) the representative parties will fairly protect the interests of the class."

Rule 23(b)(3) adds the further requirements that the common questions predominate over questions affecting only individual members of the class and that the class

1. The affidavit in *SEC v. Westland Minerals Corp.*, Civil No. 72-2337 (E. D. Pa.), a related case, states: "[T]he salesmen would tell the potential investor that [the promoters] had for their consideration a program featuring a 200% tax write-off which means that the investor would be using strictly tax dollars if he was in the 50% tax bracket."

action procedure is preferable to any other methods for the "fair and efficient adjudication of the controversy." Defendant vigorously argues that plaintiff has not met these standards.

Preliminarily we note that suits attempting to redress alleged violations of rule 10b-5 may be particularly appropriate for maintenance as class actions. Often the individual injury suffered will not justify the expense of litigating what are often complex facts and difficult issues of law. *See Green v. Wolf Corp.*, 406 F. 2d 291, 296-97 (C. A. 2, 1968), *cert. denied*, 395 U. S. 977, 89 S. Ct. 2131, 23 L. Ed. 2d 766 (1969). The class action mechanism not only provides an economical means of redress for those wronged, but also serves to conserve valuable judicial resources.

A. *Numerosity*

Plaintiff alleges in his complaint that there are between 200 and 300 members in the class he seeks to represent. This allegation is supported by an affidavit filed by an SEC investigator in *SEC v. Westland Minerals Corp., supra*, which states that there were 283 investors in the WMC Ohio 1971 program. For the purposes of this motion, we accept plaintiff's corroborated allegation.

Defendant argues that there can be only eight members of the class since plaintiff purchased a ⅛ share and presumably seven other investors purchased the remainder. We find this argument meritless as well as disingenuous. Defendant's opinion letter itself clearly recognized that WMC would create multiple limited partnerships as part of its program. The letter was for general application to all of them.

We are therefore convinced that joinder of all parties would be impracticable and that the numerosity re-

quirement is met. *Cannon v. Texas Gulf Sulphur Co.*, 47 F. R. D. 60, 63 (S. D. N. Y. 1969); *Fidelis Corp. v. Litton Industries, Inc.*, 293 F. Supp. 164, 170 (S. D. N. Y. 1968).

B. *Common Questions and Their Predominance*

Rule 23(a)(2) requires that there be questions of law or fact common to the class, and rule 23(b)(3) contains the further requirement that these common questions predominate over any questions which are applicable only to individual class members. *See Fisher v. Kletz*, 41 F. R. D. 377, 380 (S. D. N. Y. 1966).

Defendant argues that common questions do not predominate because each plaintiff will have to prove personal reliance as an element of his or her claim. Such proof, it argues, prevents plaintiff from meeting the common question requirement. While the requirement of proof of reliance is not totally free from doubt,[2] in this circuit, with two exceptions, it would appear that proof of "reliance is necessary under rule 10b-5." *Landy v. Federal Deposit Insurance Corp.*, 486 F. 2d 139, 170 (C. A. 3, 1973), *cert. denied*, 416 U. S. 960, 94 S. Ct. 1979, 40 L. Ed. 2d 312 (1974).

One of the two exceptions to the reliance requirement arises when the defendant fails to disclose material facts which it has a duty to disclose (nondisclosure). *Rochez Brothers Inc. v. Rhoades*, 491 F. 2d 402 (C. A. 3, 1974). The other exception occurs when the misrepresentation is contained in documents "prepared for or disseminated to the public or the stockholders." *Landy, supra*, 486 F. 2d at 170; *see Kohn v. American Metal Climax, Inc.*, 458 F. 2d 255, 269 (C. A. 3), *cert. denied*, 409 U. S. 874, 93 S. Ct. 120, 34 L. Ed. 2d 126 (1972); *Dorfman v. First Boston Corp.*, 62 F. R. D. 466, 476-77 (E. D. Pa. 1974). Where

2. *See Note, The Reliance Requirement in Private Actions Under SEC Rule 10b-5*, 88 Harv. L. Rev. 584 (1975).

either one of these exceptions applies and there is a showing of materiality, the plaintiff is entitled to a rebuttable presumption of reliance. *Rochez Brothers, Inc. v. Rhoades, supra,* at 410; *Landy, supra,* at 170.

While plaintiff and defendant are at issue over whether defendant's opinion letter comes under either of the exceptions, this is an issue we need not, and do not, decide at this early juncture.[3]

The central issue in this case, common to the class which plaintiff seeks to represent, is whether the statements and omissions made in defendant's opinion letter are materially false and/or misleading. *See Dorfman v. First Boston Corp., supra,* at 474.

If at trial it is determined that individual proof of reliance is required in this case because it does not fall within either of the two enunciated exceptions, then separate hearings can be held to determine which members of the class in fact relied on defendant's letter. This is the approach which the vast majority of courts faced with this problem have advocated. *See, e.g., Green v. Wolf Corp., supra,* at 301; *Entin v. Barg,* 60 F. R. D. 108, 112-13 (E. D. Pa. 1973); *In Re Penn Central Securities Litigation,* 347 F. Supp. 1327, 1344-45 (E. D. Pa. 1973), *aff'd,* 494 F. 2d 528 (C. A. 3, 1974). While this would be an issue individual to each plaintiff, it is insufficient to prevent plaintiff from meeting the common questions requirements. Rule 23(b)(3) only requires a predominance of common questions, not a unanimity of them. To deny class action status because of the reliance requirement

3. An analysis of plaintiff's theories of liability reveals a number of nondisclosure claims as well as misrepresentation claims. Which of these, if any, he will ultimately be able to prevail on at trial we have no way of knowing. Similarly, whether defendant's letter is one which was "prepared for or disseminated" to the investing public is a question which will have to await trial.

would in large part eviscerate the policies served by rule 10b-5. *Green v. Wolf Corp., supra,* at 301.

If, on the other hand, it is established that this is a case where a presumption of reliance arises, then a showing of materiality, a question common to the class, would be sufficient. *Affiliated Ute Citizens v. United States,* 406 U. S. 128, 153-54, 92 S. Ct. 1456, 31 L. Ed. 2d 741 (1972); *Rochez Brothers, Inc. v. Rhoades, supra,* at 408. There might, of course, remain the necessity for individual determinations regarding those plaintiffs for whom defendant seeks to rebut the presumption of reliance. But this necessity does not alone preclude the presence of common questions and their predominance.

In any case, the determination of whether each member of the class must prove reliance is itself a question common to the class. *See Gold v. DCL Inc.,* 399 F. Supp. 1123, 1129 (S. D. N. Y. 1973).

Recent responses to interrogatories have demonstrated that plaintiff never saw defendant's opinion letter before the institution of this lawsuit. Plaintiff's answers state that he became aware of the contents of these letters through oral statements made to him by one of WMC's salesmen and by another investor in the program. Defendant argues that because oral representations are involved, this is a particularly inappropriate case for class action status. "The propriety of a class action when misstatements are oral is generally considered to be doubtful." 6 L. Loss, *Securities Regulation* 3497-50 (2d ed. 1969 supp.). *See also Stevens v. Woodstock,* 372 F. Supp. 654, 656-57 (N. D. Ill. 1974); *Morris v. Burchard,* 51 F. R. D. 530, 535 (S. D. N. Y. 1971); *Moscarelli v. Stamm,* 288 F. Supp. 453, 462 (E. D. N. Y. 1968).

This argument we think misses the mark. It may have merit where the suit is founded on oral representations. But that is not this case. The representations on

which plaintiff's suit is based were written. They were those which were contained in the opinion letter. The oral statements were nothing more than the means by which the written contents of defendant's letter were conveyed to plaintiff. The statements in the opinion letter are common to all members of the class, although the class members may have learned of them in a contrariety of ways. The oral statements are only relevant, if at all, on the question of reliance.[4] If separate hearings are ultimately required on the issues of reliance and/or damages, some additional time and effort will be required because of the oral statements, but it should not be overwhelming. In any case, with the presence of a common core which predominates, considerations of judicial efficiency and economy, overall expense and uniformity will be furthered by permitting this case to proceed as a class action. *See, e. g., Lamb v. United Security Life Co.*, 59 F. R. D. 25, 39 (S. D. Iowa 1972). If plaintiff's case is as weak as defendant insists,[5] then this case provides it an economical vehicle for establishing its innocence as to all members of the class. For it is only if plaintiff prevails on all of the common issues that the need will arise for split trials on whatever individual issues remain. *See Frankel*, Some Preliminary Observations Concerning Civil Rule 23, 43 F. R. D. 39, 47 (1967).

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4. Absent a conspiracy, only truthful representations made to plaintiff by others about the contents of defendant's letter would be relevant to the question of reliance. To the extent that plaintiff relied on false or misleading statements about what was contained in defendant's opinion letter, this would not be sufficient to prove reliance as to that letter.

5. A question which is irrelevant to a motion for class action status. *Eisen v. Carlisle & Jacquelin (Eisen IV)*, 417 U. S. 156, 177-78, 94 S. Ct. 2140, 40 L. Ed. 2d 732 (1974); *Kahan v. Rosenstiel*, 424 F. 2d 161, 169 (C. A. 3), *cert. denied*, 398 U. S. 950, 90 S. Ct. 1870, 26 L. Ed. 2d 290 (1970).

C. *Typicality and Fair Representation*

It has frequently been suggested that the typicality requirement of rule 23(a)(3) is "ambiguous," or even that it adds nothing to the other requirements of rule 23. *E. g., Fox v. Prudent Resources Trust*, 69 F. R. D. 74 (E. D. Pa. 1975); 3B J. Moore, *Federal Practice* ¶ 23.06-2 (2d ed. 1975). However, whether derived from rule 23(a)(3) or the fair representation standard of 23(a)(4), a further requirement is that the claims of the representative be coextensive with the claims of the class. *State of Minnesota v. United States Steel Corp.*, 44 F. R. D. 559, 566 (D. Minn. 1968) (citing cases). In the instant case we are satisfied that plaintiff meets this standard for the class which he seeks to represent.

While plaintiff stands in a slightly different posture from those who actually received defendant's opinion letter before purchasing, this does not affect the typicality of his claims. For if proof of reliance is required, plaintiff will attempt to prove his reliance based on the oral representations made to him,[6] while others will attempt to prove their reliance by having received and read defendant's opinion letter. In any case, as we pointed out in *Dorfman v. First Boston Corp., supra*, at 478, we do not consider a motion for class determination to be the proper forum to examine the sufficiency to the individual claims

6. If in fact the oral statements made to plaintiff about defendant's letter influenced his decision to invest, we see no reason why this will not satisfy the reliance requirement. There is no qualitative difference between visual apprehension of false written representations and aural acquisition of true statements concerning the contents of the same false written representations. And we do not think this fact is changed because the (presumably accurate, *see* note 4, *supra*,) oral representations about defendant's letter were made by persons other than defendant. *Cf. Dorfman v. First Boston Corp.*, 62 F. R. D. 466, 478 (E. D. Pa. 1974).

of the named plaintiff. *See Kahan v. Rosenstiel,* 424 F. 2d 161, 169 (C. A. 3), *cert. denied,* 398 U. S. 950, 90 S. Ct. 1870, 26 L. Ed. 2d 290 (1970); *B & B Investment Club v. Kleinert's Inc.,* 62 F. R. D. 140, 144 (E. D. Pa. 1974).

In addition to the typicality standard, plaintiff must meet the adequate representation requirement of rule 23(a)(4). This is met if the court is convinced that plaintiff and his counsel will adequately and vigorously prosecute the action and if there is no conflict of interest between the class representative and the rest of the class. *Dorfman v. First Boston Corp., supra,* at 473; *Dolgow v. Anderson,* 43 F. R. D. 472, 494 (E. D. N. Y. 1968); 3B J. Moore, *Federal Practice* ¶ 23.07 (2d ed. 1969).

Defendant argues that plaintiff's failure to name as defendants in this case the promoters of the WMC partnership scheme compels the conclusion that plaintiff will not adequately represent the interests of the class. We find this contention without merit. Plaintiff is surely entitled to exercise some discretion in deciding which defendants to sue. *See Dorfman v. First Boston Corp., supra,* at 474. We are satisfied that plaintiff meets the requirements of rule 23(a)(4).

For all of the foregoing reasons, we are convinced that a class action is the best method for adjudication of these claims. Allowing this case to proceed as a class action will minimize the overall burden on both defendant and the plaintiff class, as well as the court.

UNITED STATES DISTRICT COURT,
E. D. PENNSYLVANIA.

Stanley SHARP et al.

v.

COOPERS & LYBRAND.

No. 75-1313.

Sept. 27, 1978.

JOSEPH S. LORD, III, *Chief Judge.*

Plaintiffs, investors in an oil drilling venture, alleged in this class action that the defendant, a major accounting firm, is liable to them for misstatements in several opinion letters which advised them as to the supposed tax consequences of those investments. Four theories of liability have been advanced by the plaintiffs: (1) liability for violation of § 10(b) of the Securities Exchange Act of 1934, 15 U. S. C. § 78j(b), and of Rule 10b-5 promulgated thereunder, 17 C. F. R. § 240.10b-5, by employees of the defendant (Count One); (2) liability as a controlling person of its employees under § 20(a) of the Securities Exchange Act (also Count One); (3) fraudulent misrepresentations by defendant's employees (Count Two); and (4) negligent breach by employees of the defendant of their common law duty owed to plaintiffs (Count Three). We have pendent jurisdiction over the last two claims.

We certified a class consisting of all persons who purchased these securities after July 22, 1971, 70 F. R. D. 544 (E. D. Pa. 1976). There ensued an apparent novelty in our jurisprudence: a jury trial of issues common to the class under the Rule 10b-5, § 20(a) and pendent claims. These issues included foreseeability of damages, the exer-

cise of reasonable care, whether there were misrepresentations and omissions and, if so, their materiality and scienter, and whether the defendant controlled an employee for § 20(a) purposes and adequately supervised him. We bifurcated the trial, and individual issues such as reliance, amount of damages and statute of limitations defenses have not yet been tried. After the jury returned answers to special interrogatories, plaintiffs moved for judgment n. o. v. with respect to one of those answers and to vacate the judgment as to Count Three (negligence), and the defendant moved for judgment on all counts in accordance with those answers, for judgment n. o. v. on the fraud and Securities Exchange Act counts and for a new trial on various grounds. We will grant only the plaintiffs' motion to vacate the judgment as to Count Three.

I. Facts at Trial:

Plaintiffs are persons who purchased limited partnership interests in oil wells to be drilled in Kansas and Ohio, of which Westland Minerals Corporation (WMC) was general partner and promoter. As a result of criminal fraud by WMC, many of these wells were never drilled and much of the invested money was diverted to WMC's own use. Economic Concepts, Inc. (ECI), the selling agent for these limited partnerships, and WMC sought to engage in April 1971 the services of defendant in rendering opinions as to the federal income tax consequences of these limited partnerships. In July the defendant decided to write such opinion letters, and on July 22, 1971, an opinion letter signed by a Coopers & Lybrand partner in its name was sent to Charles Raymond, president of WMC, stating that "based solely on the facts contained [in the WMC Limited Partnership Agreement] and without verification by us" a limited partner who contributed $65,000 in cash could deduct approximately $128,000 on his 1971

tax return. That letter was drafted by defendant's employee Herman Higgins, who was at that time a tax supervisor working directly under the supervision of four partners of defendant. The letter was written specifically for the use of one Muhammed Ali, a potential WMC investor, with regard to reducing the amount of taxes that would be withheld from a fight purse. In early October 1971 Higgins told David Wright, a partner in the defendant firm, that copies of the July 22 letter had been shown to individual investors besides Ali, and Wright determined that a letter which would be seen by other investors should be more complete. Higgins redrafted the opinion letter, and on October 11, 1971, defendant sent another opinion letter, signed in defendant's name by Wright, and a covering letter to Raymond.

The jury found that the October 11 letter contained both material misrepresentations and material omissions, and that Higgins acted either recklessly or with intent to defraud in preparing the letters. Much of the evidence concerning those misrepresentations and omissions and their recklessness came from plaintiffs' expert witness, Professor Bernard Wolfman of the Harvard Law School, a specialist in federal income taxation. Most of his testimony was not rebutted by the defendant. Professor Wolfman explained the principles behind this tax shelter: a taxpayer who in 1971 contributed $25,000 to a partnership involved in a bona fide oil drilling venture, which then obtained for each $25,000 contribution an additional $25,000 bona fide bank loan that was fully secured by partnership property (the as yet undrilled wells) and then expended all of that $50,000 for drilling, could under the law applicable in 1971 deduct the full $50,000 from his taxable income. The effect would be to accelerate the tax deduction available to the investor in 1971. Professor Wolfman's expert testimony in concert with other evi-

dence provided the basis for the jury's findings that the October 11 letter misrepresented or omitted to state material facts in at least three ways.

First, Professor Wolfman testified that writing such a letter was reckless on its face in that it omitted to state that the non-recourse loan which the letter assumed lending institutions would make to WMC, the value of which loan would be deductible by the taxpayer according to the opinion letter, would have to be secured by collateral (*i.e.*, the oil wells) whose value was equal to or greater than the amount of that loan. Non-recourse loans of the type contemplated by the opinion letter (*i.e.*, with no personal liability to the limited partners) are very rarely entered into banks for oil drilling ventures, according to Professor Wolfman, because it is hard to secure them fully by undrilled wells, whose value is not known. Unless the value of the property used by the partnership to secure the loan were equal to the amount of the loan, Professor Wolfman explained, the amount of the loan would not be deductible to the limited partner under § 752(c) of the Internal Revenue Code. To assume this unlikely fact that the loans would be thus secured without stating the assumption was itself reckless, he said.

Second, the plaintiffs introduced evidence, principally through Higgins' testimony before a grand jury, that at the time Higgins drafted the October 11 letter he was aware of a number of facts because of his close relationship with ECI and WMC. In particular, this evidence suggested that Higgins as of October 11: (a) had recommended to WMC that it take the bank loans through mere bookkeeping transactions "without having to make a bank loan in the normal sense that we think of," (b) knew that WMC had acquired a bank, International Bank & Trust of the Bahamas (IBT), (c) knew that IBT

was insolvent, or at least unable to make the loans necessary to fund the oil drilling ventures contemplated by the WMC limited partnership agreements and (d) knew that the actual drilling costs for each limited partnership would be less than $140,000. Higgins testified at his deposition that, while under the transaction contemplated by this "paper loan" WMC would not have access to the money it would "borrow" from IBT, that was "not a difference . . . that in my opinion would be that critical from the tax point of view." As it turned out, many of these facts were untrue as a result of WMC's fraud.

Professor Wolfman stated that if the writer had made such a recommendation and was aware of these facts, the October 11 letter contained a number of misstatements: that the driller would receive $140,000 in cash, that there would be partnership borrowing and that such borrowing would be from a suitable bank or other lending agency. These misrepresentations, which the jury could have found were intentional or at least reckless, in turn rendered the opinion as to tax consequences a misrepresentation, again at best recklessly made, because it was based on assumptions known to be false.

Third, the plaintiffs established that as of October 11 Higgins had decided to leave defendant's employ and that he had as of October 8 taken a leave of absence and was remaining there only to finish the opinion letter. There was evidence that by October 6 Higgins was working closely with ECI, WMC's selling agent, and on October 16 he got powers of attorney from Raymond to execute and file papers for WMC, of which Raymond was president, and for IBT, of which he was board chairman. Professor Wolfman testified that it was improper for an employee of an accounting firm who was employed by ECI to write a tax opinion letter and that the failure to

disclose his relationship with the selling agent would be a material omission which would appear to have been intentional or reckless.

The jury concluded that, while Higgins caused the material misrepresentations and omissions in the October 11 letter recklessly or with an intent to defraud, no partner of the defendant firm caused any misstatements with such scienter. It also found no misrepresentations or omissions in the July 22 letter, so that liability is limited to those relying on the October 11 letter. With respect to the plaintiffs' negligence claim, the jury determined that defendant failed to exercise reasonable care but said that it was not foreseeable to the defendant that plaintiffs would be injured as a result of its negligent misrepresentations. With respect to common law fraud, the jury determined there was clear and convincing proof that the misrepresentations and omissions were made recklessly but not that they were made with knowledge and intent to deceive. Again, liability can arise only from reliance on the October 11 letter. The responses to interrogatories under § 20(a) of the Securities Exchange Act were that the defendant had the power to control Higgins' wrongful activities and that its good-faith defense of reasonably adequate supervision of Higgins had not been made out.

II. Common Law Negligence:

After considerable dubitation as to whether the defendant could owe a duty to the plaintiff investors to exercise reasonable care in writing its opinion letters, we charged the jury and included interrogatories as to negligence. The questions we deemed common to the class were the existence of a duty to the plaintiffs and the defendant's standard of care. After the jury found that the defendant was negligent but that the named plaintiff's in-

jury was not foreseeable to it, we entered judgment for the defendant on Count Three on the ground that defendant owed no duty of reasonable care to plaintiffs whose injury was not foreseeable. Plaintiffs have moved for judgment n. o. v. on the foreseeability issue and assert they should be allowed to pursue individual damage claims on a negligence theory.

There looms a threshold question of what common law governs as to this pendent claim. As a federal court exercising pendent jurisdiction, we are bound to invoke the choice of laws rules of the forum state, 1A *Moore's Federal Practice* ¶ 0.305[3] at 3056 (1977), at least where there is direct authority from the highest court of a state. *Cf. Towner v. Commissioner of Internal Revenue,* 182 F. 2d 903, 907 (2d Cir.), *cert. denied, sub nom. Estate of Farrell,* 340 U. S. 912, 71 S. Ct. 293, 95 L. Ed. 659 (1950). The controlling Pennsylvania choice of laws principle in tort cases generally is that enunciated in *Griffith v. United Air Lines, Inc.,* 416 Pa. 1, 203 A. 2d 796 (1964), that the law of the state bearing the most significant relationship with the occurrences and parties in a case ought to be applied. Neither party has argued on these motions that the selection of applicable state law is significant or that a particular state law should apply. We believe, to the contrary, that determining whose law applies might be crucial to the liability of the defendant under the negligence claim on the issue of duty.

Our difficulty with making a choice of law analysis at this point is that we do not yet know in the case of each individual plaintiff which state has the most significant relationship with the occurrences and the parties. Normally, in a tort case this will be the state in which the injury occurred. However, individual cases may contain individual factors which could cause us, under Pennsylvania's choice of law rules, to look to a state other than the state of injury.

But even if we were to reach the usual result in tort cases and apply the law of the state of injury, we still do not know which law to apply since on this record we do not know the state in which each of the individual plaintiffs was injured. That the interests of more than one state are involved is inevitable. The problem is that we do not know on this record how many or which states are involved with respect to each plaintiff's claim. Therefore, any discussion of the law of any given state at this time would be both premature and futile. Since the pendent common law claims involve several state law questions, such as the duty of accountants to third persons, reliance, statute of limitations defenses and damages, it is manifestly impossible for us to decide those questions as to each individual state until we first determine which state law to apply.

The plaintiffs have moved for judgment n. o. v. with respect to the jury's finding that the defendant could not foresee that the named plaintiff would be likely to be injured by its negligence. Whatever its merits, we are unable to consider this motion because the plaintiffs did not move for a directed verdict under F. R. Civ. P. 50(a) as to foreseeability or as to Count Three generally. A motion for judgment n. o. v. based on a ground not raised in a party's motion for a directed verdict cannot be granted. *C. Albert Sauter Co., Inc. v. Richard S. Sauter Co., Inc.*, 368 F. Supp. 501, 509 (E. D. Pa. 1973); 5A *Moore's Federal Practice* ¶ 50.08, at 50-86 & n. 3 (1977). The Third Circuit has interpreted strictly the requirement of F. R. Civ. P. 50(b) that a motion for a directed verdict after the presentation of all evidence is a prerequisite to a motion for judgment n. o. v. *DeMarines v. KLM Royal Dutch Airlines*, 580 F. 2d 1193 at 1195 n. 4 (3d Cir. 1978); *Lowenstein v. Pepsi-Cola Bottling Co. of Pennsauken*, 536 F. 2d 9 (3d Cir.), *cert. denied*, 429

U. S. 966, 97 S. Ct. 396, 50 L. Ed. 2d 334 (1976); *Beebe v. Highland Tank and Manufacturing Co.*, 373 F. 2d 886 (3d Cir.), *cert. denied sub nom. National Molasses Co. v. Beebe*, 388 U. S. 911, 87 S. Ct. 2115, 18 L. Ed. 2d 1350 (1967). *See also* 9 C. Wright & A. Miller, *Federal Practice & Procedure* § 2537, at 596-98 (1971). Indeed, to entertain the plaintiffs' motion might deprive defendant of its Seventh Amendment rights to a trial by jury on Count Three as to foreseeability. *Lowenstein v. Pepsi-Cola Bottling Co. of Pennsauken*, 536 F. 2d at 11; *Sulmeyer v. Coca-Cola Co.*, 515 F. 2d 835, 846 n. 17 (5th Cir. 1975), *cert. denied*, 424 U. S. 934, 96 S. Ct. 1148, 47 L. Ed. 2d 341 (1976), *citing Slocum v. New York Life Insurance Co.*, 228 U. S. 364, 33 S. Ct. 523, 57 L. Ed. 879 (1913). The importance of the policies served by the Rules and the Seventh Amendment forbids us under the law of this circuit to consider plaintiff's arguments in chambers that plaintiffs' injuries were as a matter of law foreseeable as curing the failure to move for a directed verdict as to that interrogatory on that basis. *Lowenstein v. Pepsi-Cola Bottling Co. of Pennsauken*, 536 F. 2d at 12 & n. 7. The plaintiffs' motion for judgment n. o. v. therefore will be denied.

Although we cannot grant plaintiffs' motion, we conclude nevertheless in light of the uncertainty as to what state law applies that judgment should not have been entered as to any plaintiff on Count Three. For at least some plaintiffs, the lack of privity with defendant might not foreclose the existence of a duty. Similarly the nonforeseeability found by the jury might not foreclose all plaintiffs. It is possible that under the law of some states, foreseeability is not required to impose a duty on accountants to exercise reasonable care. More likely, some states may impose liability on accountants for negligence to all persons whom the accountants foresaw or should have

foreseen would have *used* or would have *relied* on the opinion letter rather than those whose injury was foreseeable. *See Restatement (Second) of Torts* § 552 (1965) (limiting liability for negligently supplied false information without direct reference to foreseeability) and Illustrations 5, 6. Because there is no legal or factual finding which forecloses all plaintiffs from recovery on Count Three, we will vacate our judgment for defendant on that count.

III. Common Law Fraud and Foreseeability:

Defendant contends both that the jury's finding of non-foreseeability of injury compels judgment in its favor on Count Two, alleging fraudulent misrepresentation, and that it is entitled to judgment n. o. v. because there was no evidence of its scienter. We are again thrust into a situation in which we cannot decide what state law to apply without knowing with regard to each plaintiff all the states, laws and interests involved, and we are therefore unable to grant the defendant's motions at this time.

IV. Higgins' Rule 10b-5 Violations:

A. *Foreseeability and Rule 10b-5.*

The jury determined that Herman Higgins made material misrepresentations and omissions in the October 11 opinion letter either recklessly or with intent to defraud. The defendant advances several grounds why it is entitled nonetheless either to a verdict in its favor on Count One, alleging violation of Rule 10b-5 under § 10(b) of the Securities Exchange Act, or to a new trial on that count. Among these is the contention that the jury's finding of non-foreseeability of injury compels such a judgment in order to make the verdict on all counts consistent with the jury's answers to interrogatories, and that we must take the view of the case that renders these answers

consistent, *Atlantic & Gulf Stevedores, Inc. v. Ellerman Lines, Ltd.*, 369 U. S. 355, 82 S. Ct. 780, 7 L. Ed. 2d 798 (1962).[1] Underpinning this argument is a failure to ask the crucial question, "foreseeability of *what?*" and to make distinctions among the various possible answers. The foreseeability which is required under Rule 10b-5 is not foreseeability that a plaintiff might be injured, but merely that the defendant knew or should have known the opinion letter would be promulgated to investors.

The defendant is correct, however, in stating that the Third Circuit requires foreseeability as an element of a 10b-5 claim. In *Landy v. Federal Deposit Insurance Corp.*, 486 F. 2d 139, 168 (3d Cir. 1973), *cert. denied*, 416 U. S. 960, 94 S. Ct. 1979, 40 L. Ed. 2d 312 (1974), the court held that an accountant's alleged misstatements in reports could not be the basis of a 10b-5 action because

> "None of the directors' reports was made in a manner reasonably calculated to influence the investing public [and there] is no proof that any were disseminated to the public or that any investor saw them except for Landy, a director and counsel for the bank."

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1. Plaintiffs contend that we cannot consider the defendant's motion with respect to the lack of foreseeability under the securities law count because that ground was not raised in the defendant's motion for a directed verdict pursuant to F. R. Civ. P. 50(a) or in its motion for judgment n. o. v. under F. R. Civ. P. 50(b). It is true, as we noted in Part 1, *supra*, that allowing the grounds raised in a motion for judgment n. o. v. to exceed those advanced in a motion for a directed verdict would violate Rule 50 and might affront the Seventh Amendment rights of the non-moving party as well. This argument fails to recognize, however, that the defendant's motion on this ground is for judgment *in accordance with* the verdict, notwithstanding it. No constitutional and Rule 50 problems are created by permitting such a motion to be made and to raise issues for the first time after trial, and there is no requirement in Rule 50 as to such motions. Indeed, when else could such a motion be made?

See also Wessel v. Buhler, 437 F. 2d 279, 282 (9th Cir. 1971); *SEC v. Texas Gulf Sulphur Co.*, 401 F. 2d 833, 860-62 (2d Cir. 1968) (en banc), *cert. denied sub nom. Coates v. SEC*, 394 U. S. 976, 89 S. Ct. 1454, 22 L. Ed. 2d 756 (1976). As we concluded in *SEC v. Penn Central Co.*, 450 F. Supp. 908, 912-13 (E. D. Pa. 1978), the "in connection with" requirement of Rule 10b-5[2] imposes in these cases the limitation that defendants can be liable for misrepresentations and omissions only if the defendants reasonably could foresee that these misstatements would be used in connection with the purchase or sale of a security—*i.e.*, would go to a class or persons (including the plaintiff or plaintiffs in a private damage action) for their consideration in deciding whether to purchase or whether to sell securities. *Accord, Competitive Associates, Inc. v. Laventhol, Krekstein, Horwath & Horwath*, 516 F. 2d 811, 815 (2d Cir. 1975). Defendant points to no evidence, nor could it, suggesting non-foreseeability in this sense. We hold as a matter of law that the defendant foresaw and reasonably could foresee that the October 11 opinion letter would be shown to potential investors in WMC limited partnerships, and we therefore conclude that this letter was used in connection with the purchase of those partnership interests.[3]

In so holding, we conclude that an accounting firm's rendering of opinions to a client as to the tax consequences

2. The rule proscribes fraud "in connection with the purchase or sale of securities." 17 C. F. R. § 240.10b-5.

3. The same evidence which compelled our finding as a matter of law that defendant foresaw WMC's use of this letter to show to investors leads us to find as a matter of law that this opinion was in connection with the purchase or sale of a security. Defendant contends we erred in thus holding the "in connection with" requirement of Rule 10b-5 was met and contends that as a matter of law this element was lacking, but has cited no authority for that proposition.

of purchases and sales of the client's securities, where the firm is or should be aware the opinion will be disseminated to potential purchasers and sellers of those securities, is analogous for Rule 10b-5 purposes to preparing or certifying financial statements which it actually or constructively knows will be used in the same way. *See Ernst & Ernst v. Hochfelder*, 425 U. S. 185, 214 n. 33, 96 S. Ct. 1375, 1391, 47 L. Ed. 2d 668 (1976) ("experts who perform services or express opinions with respect to matters under the [Securities Exchange] Acts"); *Gold v. DCL Inc.*, 399 F. Supp. 1123, 1127 (S. D. N. Y. 1973).

The other cases from this circuit cited by defendant for the proposition that foreseeability of loss is necessary in a 10b-5 case are not relevant to this motion. The court in *Tully v. Mott Supermarkets, Inc.*, 540 F. 2d 187, 194 (3d Cir. 1976), discussed the requisite of a causal connection between fraudulent conduct and a purchase or sale of securities and concluded that the defendants' fraudulent refusal to sell stock had an insufficient causal nexus with plaintiffs' stock purchases. Similarly, Judge Adams held in *Ketchum v. Green*, 557 F.2d 1022, 1027 (3d Cir.), *cert. denied*, 434 U. S. 940, 98 S. Ct. 431, 54 L. Ed. 2d 300 (1977), that the fraud-sale of securities relationship was too attenuated in a case involving an intra-corporate struggle for control. In our case the causal nexus takes a classic form, between an accountant's misrepresentation and purchases of securities, and causation follows from objective materiality, which has been proven, and subjective reliance, which has not been at issue in the trial thus far.

The other main line of authority invoked by the defendant involves the limitation of damages recoverable in a Rule 10b-5 action to those proximately caused by defendants' fraud. Courts have mentioned foreseeability of injury in that context, *e.g.*, *Garnatz v. Stifel, Nico-*

laus & Co., Inc., 559 F. 2d 1357, 1361 (8th Cir. 1977), *cert. denied*, 435 U. S. 951, 98 S. Ct. 1578, 55 L. Ed. 2d 801 (1978); *See also Miller v. Schweickart*, 413 F. Supp. 1062, 1067-68 (S. D. N. Y. 1976); 2 A. Bromberg, *Securities Law: Fraud, SEC Rule 10b-5* § 8.7(2), at 218 (1973) ("Foreseeability has a role to play in determining the measure of damages . . ."). To the extent that the jury's finding of non-foreseeability would be relevant to that issue, it cannot be deemed competent because the damages issue has not yet been tried and hence the plaintiffs were not required at the trial of common issues to prove proximately caused damages. What role, if any, foreseeability will play in that determination cannot be ascertained until a later date.

Defendant also relies heavily on *Ernst & Ernst v. Hochfelder*, 425 U. S. 185, 96 S. Ct. 1375, 47 L. Ed. 2d 668 (1976), to impose a foreseeability requirement, mainly on the bases of (1) the Securities and Exchange Commission's proposed standard for recovery for negligent violations of Rule 10b-5, which the Court rejected in holding scienter is required, *id.* at 198 n. 18, 96 S. Ct. 1375, and (2) the Court's citation of *Ultramares v. Touche, Niven & Co.*, 255 N. Y. 170, 174 N. E. 441 (1931), *id.* at 215 n. 33. The SEC proposed that a defendant's liability for negligence be limited to those persons whose *reliance* could be foreseen by the defendant, which requirement has been met here in any case. Moreover, there is no reason to expect that the Court, in rejecting the sufficiency of negligence for 10b-5 liability, in any sense adopted this limitation.[4] Nor should the citation of *Ultramares v. Touche, Niven & Co.*, in *Ernst & Ernst* and

4. Indeed, the plaintiffs point out, it is unlikely that *Hochfelder* imposes any foreseeability requirement since the Seventh Circuit had concluded in the decision below that harm to persons in the plaintiffs' limited class was not an actually foreseen result of the accountants' negligence. 425 U. S. at 192 n.9, 96 S. Ct. 1375;

in *Blue Chip Stamps v. Manor Drug Stores*, 421 U. S. 723, 747-48, 95 S. Ct. 1917, 44 L. Ed. 2d 539 (1975), suggest endorsement of a foreseeability rule. In both cases the Court echoed Chief Judge Cardozo's concern about the overbreadth of the class of plaintiffs to whom persons doing business might be liable, but neither opinion suggests limiting an accountant's liability to purchasers and sellers for *fraudulent*, as opposed to negligent conduct. Thus once there is a breach of a duty extending to persons beyond those in privity with an accountant, *i.e.*, once there is fraud and not mere failure to exercise reasonable care,

> "If the certified financial statements [or opinions] are intended to be used and are used, to the knowledge of the accountants, in the sale of securities by the company or someone else to the public, there would seem to be little question that the purchasers are persons entitled to complaint of that breach of duty, even under Cardozo's opinion in the *Ultramares* case which is discussed in *Ernst & Ernst*."

R. Jennings & H. Marsh, *Securities Regulations: Cases and Materials* 1132 (1977).

B. Recklessness and Rule 10b-5.

In moving for judgment n. o. v. and for a new trial, defendant takes the alternative positions that it is entitled to judgment because reckless conduct is not grounds for 10b-5 liability and that our charge as to recklessness

4. (Cont'd.)

503 F. 2d 1100, 1107 (7th Cir. 1974). The Court equated that finding with *non-foreseeability of use* of the accountant's audit by the client. *Id.* at 215 n.33, 96 S. Ct. 1375. Had the Court deemed foreseeability of either sort necessary for liability under Rule 10b-5, its absence would have determined the case or at least ought to have been mentioned by the Court to support its holding.

erroneously defined that legal standard. The former position was rejected expressly by the Third Circuit in *Coleco Industries, Inc. v. Berman*, 567 F. 2d 569 (3d Cir. 1977), where it held in accordance with other courts which had decided the issue, explicitly unresolved in *Hochfelder*, 425 U. S. at 194 n. 12, 96 S. Ct. 1375, that recklessness is sufficient to impose such liability. Concluding that the defendants' conduct was not reckless under any of the judicial standards of recklessness, the Third Circuit in *Coleco* did not expound upon the precise standard defining the lower boundary of 10b-5 scienter. We derived our charge to the jury from the following definition of recklessness formulated in *Franke v. Midwestern Oklahoma Development Authority*, 428 F. Supp. 719, 725 (W. D. Okl. 1976), and adopted by the Seventh Circuit in three of the recklessness cases cited in *Coleco*, 567 F. 2d at 574 n. 6:

> "[R]eckless conduct may be defined as a highly unreasonable omission [or misrepresentation], involving not merely simple, or even inexcusable, negligence, but an extreme departure from the standards of ordinary care, and which presents a danger of misleading buyers or sellers that is either known to the defendant or is so obvious that the actor must have been aware of it." (citations omitted)

We do not believe this formulation to differ fundamentally from the standard adopted by the district court in *Coleco*, 423 F. Supp. 275, 296 (E. D. Pa. 1976), "a misrepresentation so recklessly made that the culpability attaching to such reckless conduct closely approaches that which attaches to conscious deception," and we originally attempted to incorporate the latter in our charge. We ultimately decided, however, that the *Coleco* language added little and that because of its legal rather than factual orientation (*i.e.*, degree of culpability) would have been

more confusing than helpful to the jury. We believe that our charge correctly reflected the meaning of "recklessness" and that the record amply supported the jury's finding that Higgins made misrepresentations or omissions either with that mental state or with intent to defraud.

C. WMC Partnerships as Securities.

Advancing the contention that the WMC limited partnership interests were securities within the meaning of the Securities Exchange Act only if the purchasers of them intended to profit from the actions of others and not if they purchased them merely for tax shelters, defendant argues that we erred in holding these interests were securities as a matter of law. *Cf.* § 3(a)(10) of the Securities Exchange Act, 15 U. S. C. § 78c(a)(10). But the very cases cited by the defendant tend to refute the proposition that there is an equation between securities and defendant's narrow definition of profit motivation. Rather, the meaning of securities under this legislation should be and has been interpreted like that under the Securities Act of 1933, *see* 2 L. Loss, *Securities Regulation* 795-96 (1961), which the Supreme Court has held to embody

> "a flexible rather than a static principle, one that is capable of adaptation to meet the countless and variable schemes devised by those who seek the use of the money of others on the promise of profits."

SEC v. Howey Co., 328 U. S. 293, 299, 66 S. Ct. 1100, 1103, 90 L. Ed. 1244 (1946). The record clearly establishes that WMC partnership shares promised to investors "profits" in the broad sense meant by the Court, based on, *inter alia*, the tax consequences forecast by defendant. Moreover, courts have more recently reinforced and in-

deed broadened the doctrine that the definition of a security is "to be liberally construed under the federal securities laws," *Ballard & Cordell Corp. v. Zoller & Danneberg Exploration, Ltd.*, 544 F. 2d 1059, 1063 (10th Cir. 1976), *cert. denied*, 431 U. S. 965, 97 S. Ct. 2921, 53 L. Ed. 2d 1060 (1977), in view of the fact that remedial legislation such as these laws should be broadly construed. *Tcherepnin v. Knight*, 389 U. S. 332, 336, 88 S. Ct. 548, 19 L. Ed. 2d 564 (1967). *See also Nor-Tex Agencies, Inc. v. Jones*, 482 F. 2d 1093, 1098 (5th Cir. 1973), *cert. denied*, 415 U. S. 977, 94 S. Ct. 1563, 39 L. Ed. 2d 873 (1974).

V. Liability of Defendant for Higgins' Rule 10b-5 Violations:

Even assuming Higgins violated Rule 10b-5 by misrepresenting and omitting to state material facts in the October 11 opinion letter, the defendant says it cannot be liable for those acts, particularly in light of the jury's finding that no partner in the defendant firm caused the misrepresentations or omissions to be made. We concluded as a matter of law that the defendant should be held liable on the basis of *respondeat superior* for acts of Higgins committed in the scope of his employment with Coopers & Lybrand, and we framed interrogatories to the jury concerning defendant's secondary liability under § 20(a) of the Securities Exchange Act, the "controlling persons" provision. The defendant argues that it is entitled to judgment on Count One due to the inapplicability of agency principles to it and the lack of evidence to sustain a § 20(a) violation, and alternatively that there should be a new trial because our charge was erroneous as to these issues.

A. *Respondeat Superior*

The Third Circuit held unequivocally in *Rochez Brothers, Inc. v. Rhoades*, 527 F. 2d 880, 884-86 (3d Cir. 1975), on the basis of the congressional intent behind the Securities Exchange Act that "the principles of agency, i.e., *respondeat superior*, are inappropriate to impose secondary liability in a securities violation case." *Id.* at 884. The plaintiff contends that the court undercut this holding in *Gould v. American-Hawaiian Steamship Co.*, 535 F. 2d 761 (3d Cir. 1976), by suggesting that under *Rochez* there can be primary as opposed to secondary liability under *respondeat superior*. We do not believe that any such distinction exists, and we read *Gould* as reaffirming this aspect of *Rochez*, 535 F. 2d at 778-79.

Rochez expressly limited this holding, however, as follows:

> "We are not faced with the type of relationship that prevails in the broker-dealer cases where a stringent duty to supervise employees does exist. [footnote omitted]. This duty is imposed to protect the investing public and make brokers aware of the special responsibility they owe to their customers. We can find no reason to impose this same duty in a situation like the one presently before us where the parties were dealing for themselves and for their own accounts."

527 F.2d at 886. *See also Thomas v. Duralite Co., Inc.*, 524 F. 2d 577, 586 n. 4 (3d Cir. 1975). We believe this carefully drawn limitation suggests that in this circuit broker-dealers are liable under normal agency principles for violations of securities laws by their employees in the course of their employment, and the Third Circuit's opinion in *Straub v. Vaisman & Co., Inc.*, 540 F. 2d 591 (3d Cir. 1976) supports that view. There the district court

held a corporation liable for violations of § 10(b) and Rule 10b-5 based on, *inter alia*, *respondeat superior*, and the court, without specific comment on the propriety of agency principles, affirmed in light of the "company's active participation in the scheme, its receipt of the benefits, and its status as a broker-dealer." *Id.* at 596. *See also, e.g., Holloway v. Howerdd*, 536 F. 2d 690, 695, (6th Cir. 1976); *Plunkett v. Dominick & Dominick, Inc.*, 414 F. Supp. 885, 887 (D. Conn. 1976). Status as a broker-dealer imposes upon the principal a stringent duty of supervising its agents and is distinguishable from the status of corporations generally in this context principally in that the broker-dealer occupies a position of public trust: the function of it and its employees is to give independent advice concerning securities transactions and thereby to affect a large number of purchases and sales by the public of securities issued by a variety of corporations and partnerships, which effect is extremely sensitive to wrongdoing by employees of a broker-dealer in the course of their work, for which the corporate entity normally is compensated.

Employees of other kinds of corporations normally can influence transactions only in its own securities and on a less regular basis, and the public does not expect that any advice they give will be independent of the corporation's interest. More importantly, it is not the primary function of the principal to exert such influence, and the corporation hence has a far less substantial reason to be aware of or responsible for wrongdoing in connection with purchases or sales of securities, which will usually be at least a frolic, if not a detour, from the employee's duties. *See, e.g., Rochez*, 527 F. 2d at 884-85. The Third Circuit in that case consequently declined to impose on corporations a duty to supervise and oversee the securities transactions of directors and employees of such corporations by applying *respondeat superior*. *Id.* at 885-86.

While we know of no case discussing the applicability of *respondeat superior* to accounting firms, we believe the "special duty" exception applies to them because their roles in securities transactions resemble more closely those of broker-dealers than those of corporations generally. *See* Ruder, *Multiple Defendants in Securities Law Fraud Cases,* 120 U. Pa. L. Rev. 597, 645-46 (1972) (defendant may be primarily liable because he or it "owe[s] a duty as an accountant or a stockbroker . . ."). We conclude that defendant here is liable for any conduct of Higgins which violated Rule 10b-5 occurring in the scope of his employment.[5] While it is true that the defendant (like accountants generally) did not deal with purchasers as directly as broker-dealers do, its task in writing over its signature on the October 11 opinion letter, which it delegated in large part to Higgins, was to render an independent opinion which would influence potential investors in WMC. Moreover, Judge Newman's observation in *Plunkett v. Dominick & Dominick, Inc.*, that "[h]olding the broker-dealer liable [for an employee's 10b-5 violation] allocates the risk of loss to the entity best able to prevent a loss and most able to sustain the monetary repercussions of the illegal act," 414 F. Supp. at 889, applies with equal force to accounting firms in situations such as this.

Higgins' misrepresentations were in a letter signed by a partner on defendant's behalf and came in the course of conduct for which the defendant was compensated. Professor Wolfman testified as to the high degree of care owed by accountants in such undertakings. Judge

5. That defendant here is a partnership whereas most of the authority on *respondeat superior* liability for securities laws violations by employees deals with corporate principals does not seem to us a distinction of any significance (so long as the violation was not by a partner), and neither party argues to the contrary.

Frankel had noted, in holding an accounting *firm* had no duty to disclose material facts where it had not itself made any representations or certification, that

> "Where it gives an opinion or certifies statements, an auditing firm publicly assumes a role that carries a special relatonship of trust vis-à-vis the public. The auditor in such a case holds itself out as an independent professional source of assurance that the audited company's financial presentations are accurate and reliable' [citations omitted].

Gold v. DCL Inc., 399 F. Supp. at 1127. This special relationship and duty seem to us to justify under the *Rochez* rationale imposition of *respondeat superior* liability on an accounting firm for misrepresentations of an employee which, like those here, were expressed in a firm opinion. We note, finally, that a number of courts, including the Third Circuit, have discussed the liability of accounting *firms* under Rule 10b-5 for conduct (which of course can only be done by natural persons), apparently assuming the applicability of *respondeat superior*. *See, e.g., Ernst & Ernst v. Hochfelder*, 425 U. S. 185, 96 S. Ct. 1375; *Competitive Associates, Inc. v. Laventhol, Krekstein, Horwath & Horwath*, 516 F. 2d at 815; *Landy v. Federal Deposit Insurance Corp.*, 486 F. 2d at 167-170; *Gold v. DCL Inc.*, 399 F. Supp. at 1127.

B. § 20 Liability.

Section 20 of the Securities Exchange Act provides:

> "Liability of controlling persons.
>
> (a) Every person who, directly or indirectly, controls any person liable under any provision of this chapter or of any rule or regulation thereunder shall also be liable jointly and severally with and to the

> same extent as such controlled person to any person to whom such controlled person is liable, unless the controlling person acted in good faith and did not directly or indirectly induce the act or acts constituting the violation or cause of action."

On its face, the statute seems to make the existence of a controlling person-controlled person relationship sufficient to make out a prima facie case of liability, with a defense of good faith and non-inducement available to controlling persons. The Third Circuit's latest plenary discussion of § 20(a) in *Gould v. American-Hawaiian Steamship Co.* followed this approach when it said that two defendants, though controlling persons, could defeat liability if they could establish this two-fold statutory defense and noted the comparative benefit to plaintiffs of proceeding under § 20(a) relative to an aider-abettor theory, where the burden of proof would be on plaintiffs as to all elements. 535 F. 2d at 779-781. *See also Stern v. American Bankshares Corp.*, 429 F. Supp. 818, 824 (E. D. Wis. 1977); Ruder, *Multiple Defendants in Securities Law Cases*, 120 U. Pa. L. Rev. 597, 602 (1972).

Accordingly, we charged the jury first as to the law concerning whether defendant was a controlling person with respect to Higgins and framed the question as to whether Coopers & Lybrand "had the power or potential power to influence and control the activities" of Higgins. The jury decided it had that power. The courts have not stated explicitly whether the existence of this relationship *vel non* is a question of fact, as we believe it is, or of law. If it is the former, we believe we properly instructed and formulated the interrogatory to the jury under *Rochez*, and that its answer to the interrogatory was amply supported by the evidence. It stands as a finding that Coopers & Lybrand was a controlling person of Higgins with regard to the drafting of the WMC opinion letter. The

project of writing that letter was, after all, firm business which was done under the direction of partners and for which the defendant was compensated. If this is a question of law, we hold likewise that defendant was a controlling person under the SEC's and this circuit's liberal construction of "control." *See Gould,* 535 F. 2d at 779, and *Rochez,* 527 F. 2d at 890, quoting and apparently adopting the SEC's definition, 17 C. F. R. § 240.-12b-2(f) ("the possession, directly or indirectly, of the power to direct or cause the direction of the management and policies of a person . . .").

We next asked the jury whether the defendant exercised reasonably adequate and sufficient supervision over Higgins, on the premises that a showing of such supervision by defendant would make out the good faith aspect of the two-part § 20 defense just as it would for broker-dealers and that this was the only basis on the record for a good faith defense. *See Zweig v. Hearst Corp.,* 521 F. 2d 1129, 1134-35 (9th Cir.), *cert. denied,* 423 U. S. 1025, 96 S. Ct. 469, 46 L. Ed. 2d 399 (1975); *Barthe v. Rizzo,* 384 F. Supp. 1063, 1069-70 (S. D. N. Y. 1974); *Gordon v. Burr,* 366 F. Supp. 156, 168 (S. D. N. Y. 1973), *rev'd in part on other grounds,* 506 F. 2d 1080 (2d Cir. 1974); *Lorenz v. Watson,* 258 F. Supp. 724, 732-33 (E. D. Pa. 1966). The jury concluded defendant did not. Again we find this determination was supported by the evidence that, *inter alia,* David Wright (the partner who most directly was charged with supervising Higgins), never read the WMC limited partnership agreements or asked Higgins whether he had read them. Particularly in light of the fact that defendant bears the burden under *Gould* of making out this defense, we are unable to conclude that the jury simply made a mistake, as the defendant contends, and to hold as a matter of law that the defendant exercised reasonably adequate supervision.

Defendant argues that we erred in not submitting to the jury the second half of a § 20(a) defense, *i.e.*, whether the defendant directly or indirectly induced Higgins' Rule 10b-5 violations. The plaintiff did not request such a charge and we did not put this issue to the jury because there was no evidence in this case of direct or indirect inducement, other than the undisputed fact that Higgins was doing firm business when he drafted the opinion letter. Whether that constitutes inducement under § 20(a) is a question of law, but we need not resolve it in light of the jury's finding and our conclusion that the other necessary half of a § 20(a) defense, good-faith, was not made out. The statute and *Gould* make it clear that *both* parts of the defense must be made out for a controlling person to escape § 20(a) liability for a controlled person's violations.

The defendant complains that it is permitted to show and have jury findings as to *both* good faith *and* non-inducement. This argument turns the conjunctive structure of § 20(a) upside down. It is the *defendant* who must make out both elements of the *defense*, and the failure here to establish good faith precludes any need for inquiry into non-inducement, either by a jury or (as would be appropriate here) by a court in determining whether the undisputed facts amount to non-inducement. Where the resolution of an issue cannot affect the outcome of the case, a party has no "right" to have it determined. Hence the jury's findings are sufficient to impose § 20(a) liability on the defendant for Higgins' acts.

A more substantial challenge by defendant arises from a point in the Third Circuit case law construing § 20(a) which is at best ambiguous and at worst a mess. The defendant argues that our interpretation of the statute is inconsistent with that of the Third Circuit in *Rochez*, where it held "that secondary liability cannot be found

under Section 20(a) unless it can be shown that the defendant was a culpable participant in the fraud." 527 F. 2d at 890. *See also Gordon v. Burr*, 506 F. 2d at 1086; *Lanza v. Drexel & Co.*, 479 F. 2d 1277, 1299 (2d Cir. 1973). This requirement appears to combine the statutory criteria of bad faith and inducement. In so doing, *Rochez* seems to create a new requisite for § 20(a) liability and to suggest, contrary to the statute on its face, that plaintiff bears the burden of demonstrating aspects of both bad faith and inducement to make out a prima facie case. This position was squarely rejected six months later by the *Gould* court, which did not overrule *Rochez* and indeed cited it approvingly. This conflict, or at best lack of clarity, within the Third Circuit leaves us somewhat confused as to the necessary elements of § 20(a) and as to burden of proof.[6] We believe that we must resolve that problem by giving primacy to *Gould*, the most recent pronouncement of that court as to these issues under § 20(a).[7]

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6. This apparent confusion is perhaps best explained by the usual practice of non-jury trials in Rule 10b-5 cases, in which event the division between fact-finding and interpreting the law blurs and the importance of burden of proof diminishes. Courts thus can avoid this morass by finding either that *both* parts of a § 20(a) defense have been made out, in which case it is irrelevant whether the plaintiff did make out a prima facie case, or that there was culpable participation *and* the defenses were not established. Such findings render the burden of proof problem moot. In having to charge and frame interrogatories to a jury, we were not so fortunate.

7. A still more recent case, *Monsen v. Consolidated Dressed Beef Co., Inc.*, 579 F. 2d 793 (3d Cir. 1978), cites *Rochez* for the proposition that a director may not be held liable under § 20(a) without culpable participation in the unlawful activity, at 804. We hesitate to hold that this two-sentence "discussion" of § 20(a) overrules the clear language of *Gould*, putting the burden on defend-

Even under *Rochez,* however, we believe that our charge and interrogatories were correct. Even if "culpable participation" is required to make a prima facie case, we cannot agree with the defendant that the issue of its presence was properly a question for the jury. Certainly, culpable participation is a legal conclusion as well as a doctrine whose meaning at this stage, is, even to judges and lawyers, obscure to say the least. To instruct the jury adequately on the meaning of culpable participation would have been a difficult task; to ask it to pass on the matter would have been an abdication of our responsibility, particularly where the main facts of Coopers & Lybrand's role vis-à-vis Higgins were not in dispute (with the exception of the adequacy of its supervision, which the jury did pass upon). In *Rochez,* the court found a lack of culpable participation by the corporation where the violator, its president, acted for himself and traded the corporation's securities on his own account, where the corporation did not benefit from his conduct and where its other employees all were purely ministerial. 527 F. 2d at 891. Similarly, one of the Second Circuit cases from which *Rochez* gleaned the culpable participation requirement, *Gordon v. Burr,* was an instance in which the controlling person was far removed from the violation. There, a broker-dealer was deemed not to be a "culpably participating" controlling person of a salesman who violated the securities laws in sales which were not managed by the firm to a purchaser who was not a regular customer

7. (Cont'd.)

ant to make out the dual defense once shown to be a controlling person, particularly in light of *Monsen's* limitation on its face to directors—for whom, it might well be, the "culpable participation" requirement makes more sense than it does in the case of corporations and partnerships.

of the firm. 506 F. 2d at 1685-86.[8] Another case relied on in *Rochez, Kamen & Co. v. Paul H. Aschkar & Co.*, 382 F. 2d 689, 696-97 (9th Cir. 1967), *cert. granted*, 390 U. S. 942, 88 S. Ct. 1021, 19 L. Ed. 2d 1129, *cert. dismissed*, 393 U. S. 801, 89 S. Ct. 40, 21 L. Ed. 2d 85 (1968), is also distinguishable in that there the district court had found that both parts of the § 20(a) defense had been made out, good faith having been shown by due care in supervision.

While we therefore have some idea of what constitutes a lack of culpable participation under *Rochez*, we are less informed as to what amounts to its presence. In *Straub v. Vaisman & Co.*, where the Third Circuit upheld a district court holding that a corporate broker-dealer was liable under § 20(a) as well as under *respondeat superior*, the court said only that such liability attached where the corporation's "role was not merely that of a facade for fraud, but rather one of a culpable confederate." 540 F. 2d at 596. There the broker-dealer's "participation" in its president's fraud with respect to another company's securities consisted in its being a market-maker in those securities, a financial consultant to the other company and the employer of the salesman who advised the purchase of these securities to plaintiff in a telex signed in the name of the corporation.[9] The court's analysis is brief and does

8. The other Second Circuit case relied on in *Rochez, Lanza v. Drexel & Co.*, did not apply § 20(a) to specific facts.

9. We discount the significance of the district court's finding in *Straub*, noted by the Third Circuit in its decision, that the defendant corporation "had inside information . . .", *id.* at 594, because we do not understand what it means for a corporation to have information (*i.e.*, to "know" something), other than by the application of agency principles, any more than we see how a corporation can act other than through its agents. *See Rochez*, 527 F. 2d at 884.

not in any sense define the lower threshold of culpable participation. Surely defendant is incorrect, however, when it argues that it cannot be found to have been a culpable participant because the jury found that no partner (whose acts defendant seems to equate legally with its own) made misstatements recklessly or with an intent to defraud. To hold that such a finding bars § 20(a) liability would mean the section applies only where the controlling person's primary liability can be made out and thus would render § 20(a) a nullity. We reject the idea that Congress intended § 20(a) liability to be so narrow as to be virtually meaningless.

The facts in this case are clearly distinguishable from the "no culpable participation" cases decided by and endorsed by the Third Circuit and amount in our judgment to significant involvement by the defendant in the fraud. It may be, first of all, that the defendant's failure to sustain its burden as to good faith is itself sufficient to reach the legal conclusion of culpable participation, where the employee who was inadequately supervised committed the primary violation. *See DelPorte v. Shearson, Hammill & Co., Inc.*, 548 F. 2d 1149, 1154 (5th Cir. 1977); *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 438-39 (N. D. Cal. 1968), *modified on other grounds*, 430 F. 2d 1202 (9th Cir. 1970). In this case, moreover, at least three factors demonstrate defendant's culpable participation: (1) the misrepresentations and omissions were made by an employee in the scope of his work for the defendant partnership's rendering of professional services for which it was compensated, and were expressed in an opinion letter signed by a partner for the partnership; (2) that work was supposed to be supervised by partners, and the jury expressly found defendant failed to supervise it adequately; and (3) as a result of this inadequacy the defendant failed to make out its § 20(a) good faith defense. We concede

that the defendant's involvement in the fraud, while significant and much closer than that in *Rochez* or *Gordon*, was somewhat less intimate than that of the defendant in *Straub*. We believe nevertheless that broker-dealers, accounting firms or other controlling persons with special relationships to the investing public are to be judged under more stringent standards in § 20(a) cases than corporations generally, *compare Zweig v. Hearst Corp.*, 521 F. 2d at 1135, *with Hecht v. Harris, Upham & Co.*, 283 F. Supp. at 438-39. For such controlling persons, at least, these facts are sufficient to constitute "culpable participation" under *Rochez*.

VI. Other Grounds for New Trial

Defendant also argues that we erred in admitting evidence that Coopers & Lybrand (Bahamas), an affiliate of defendant, knew of the insolvency of IBT, and that we erred in bifurcating the trial between the issues common to the class and the issues relating to individual damage claims.

The plaintiffs originally intended to demonstrate that Coopers & Lybrand (Bahamas) and the defendant were partners in an international accounting partnership, and that on the basis of that relationship the knowledge of the former could be imputed to the latter. After the plaintiffs made a prima facie case of such an existence of such a partnership, we admitted evidence as to the knowledge of the Bahamian firm as to IBT's insolvency. During trial, however, the plaintiffs withdrew the contention that such knowledge could be imputed on the basis of an international partnership, and the defendant contends that the admission of that evidence prejudiced it. We reject this contention for two reasons.

First of all, the Bahamian firm's knowledge of IBT's insolvency was at least marginally relevant to two of plain-

tiffs' claims, aside from the attempt to impute that knowledge to the defendant. The plaintiffs sought to prove, but the jury rejected the contention, that David Wright, a partner of defendant, recklessly caused the misrepresentations in the October 11 letter, and the plaintiffs demonstrated that Wright had been contacted by the Bahamian firm with regard to the prospective acquisition of IBT by WMC. It was the plaintiffs' theory that Wright was reckless in not seeking information concerning IBT from the defendant's Bahamian affiliate. The evidence that that affiliate, as the auditor for IBT, learned before October 11, 1971, that the bank was insolvent was relevant under this theory in that it disclosed what Wright arguably would have learned had he opened such lines of communication. In addition, this evidence was relevant to the theory of Higgins' recklessness. The insolvency of IBT was significant as a fact that Higgins arguably either knew or was reckless in not finding out, in light of his intimate association with ECI and WMC, and the audit by Coopers & Lybrand (Bahamas) corroborated the fact of IBT's insolvency before the October 11 opinion letter was sent.

More importantly, however, we believe that any prejudice which might possibly have been done to defendant through the jury's attribution to it of the knowledge of its Bahamian affiliate was destroyed by our instructions to the jury in at least two separate places that it could not impute this knowledge to the defendant.[10] We

10. It seems clear from the answers to interrogatories that the jury did not impute this knowledge to the defendant. It found the primary violation of Rule 10b-5, and it follows that the fraud and the negligence also were committed by *Higgins*, not by the defendant or any of its partners. The liability of the defendant for Higgins' acts follows from legal principles and the jury's findings that defendant controlled Higgins and did not adequately supervise him. We fail to see how the Bahamian evidence could have affected any of these findings.

believe that these clear and repeated instructions were effective, particularly in light of our conclusion, based on our observation and the answers to interrogatories in this extremely complicated case, that this jury was an uncommonly intelligent one. Consequently, even if the Bahamian evidence were irrelevant, its admission was not error because no substantial right of the defendant was adversely affected by its admission. F. R. Ev. 103(a).

The defendant also contends that we abused the broad discretion vested in us by F. R. Civ. P. 42(b) and Rule 7(f)(10) of the Local Rules of Court for the Eastern District of Pennsylvania to separate issues for trial by bifurcating in this case the liability issues common to the class from those which would differ for each individual class member. *Compare Lis v. Robert Packer Hospital,* 579 F. 2d 819 (3d Cir. 1978). Bifurcation along these lines is unavoidable in a securities class action, and courts have uniformly permitted class actions to proceed in such cases. *See* 3B *Moore's Federal Practice,* ¶ 23.45[3] at 23-348, 23-349 & nn. 33, 34 (1978) (citing cases). Defendant did not cite in its brief supporting a motion for a joint trial any authority suggesting the impropriety of bifurcation in a securities fraud case. The principal argument of the defendant is that bifurcation is impermissible in cases where the damages and the liability issues are "so interwoven . . . that the former cannot be submitted to the jury independently of the latter without confusion and uncertainty, which would amount to a denial of a fair trial." *Gasoline Products Co., Inc. v. Champlin Refining Co.,* 283 U. S. 494, 500, 51 S. Ct. 513, 515, 75 L. Ed. 1188 (1931). Here, to the contrary, we believe that the factual parts of the individual reliance and damages issues with a brief explanation of the first jury's findings will be comprehensible to a factfinder. To hold otherwise in a securities fraud case would make it so difficult and costly

for plaintiffs to prove their cases as to diminish significantly "the ultimate effectiveness of the federal remedies" provided in these laws. 3 L. Loss, *Securities Regulation* 1819 (1961). This analysis also applies to bifurcation of liability and damages under the common law fraud count.[11] We conclude that bifurcating this trial was and will be, as well as the most efficient and perhaps the only practical way to try the suit, neither confusing to the factfinder at either stage of the case nor prejudicial to either party.

For the reasons discussed above, we will deny defendant's motions for judgment in accordance with the verdict, for judgment n. o. v. and for a new trial.

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11. The defendant also maintains that we erred in not submitting to this jury the questions of materiality and reliance under common law fraud. Clearly, reliance is an individual issue under Count Two just as it will be under Count One (if defendant chooses to rebut the presumption of reliance which apparently applies under Count One). To the extent materiality implies an objective test under state law, and hence one that is common to all plaintiffs, the jury's finding that the misrepresentations and omissions in the October 11th letter were material by Rule 10b-5 standards compels the conclusion that they were material for purposes of Count Two. *See Restatement (Second) of Torts* § 538 (2)(a); W. Prosser, *The Law of Torts* § 108, at 718-19 (1971). To the extent that the materiality of a fraudulent misrepresentation depends upon the state of mind of each individual who received the misrepresentation (*i.e.*, would this plaintiff have acted differently were it not for the fraudulent misrepresentation?), materiality properly was reserved for the individual damage trials.

UNITED STATES DISTRICT COURT,
E. D. PENNSYLVANIA.

Stanley L. SHARP et al.

v.

COOPERS & LYBRAND.

Civ. A. No. 75-1313.

June 26, 1979.

JOSEPH S. LORD, III, *Chief Judge.*

This is a securities fraud class action in which the issue of the defendant's liability has already been tried before a jury and determined in the plaintiffs' favor; the plaintiffs' individual claims for damages remain to be tried. The facts of the case are set forth in our September 27, 1978 opinion disposing of the post-trial motions [1] and will not be repeated here except as necessary. Now before us is the defendant's Rule 37 motion to compel discovery relating to the issues remaining to be tried.[2] Before we can decide this motion, however, it is necessary for us to resolve two preliminary matters: the scope of the class of investors now entitled to pursue their individual claims for damages, and the proper method for measuring those damages.

I. THE CLASS OF INVESTORS NOW ENTITLED TO PURSUE INDIVIDUAL CLAIMS FOR DAMAGES

We originally certified a class consisting of all investors who, on or after July 22, 1971, purchased the se-

1. 457 F. Supp. 879 (E. D. Pa. 1978).

2. *E.g.*, reliance on the defendant's opinion, due diligence in discovering the fraud, and the running of the statute of limitations.

curities involved in this litigation. 70 F. R. D. 544 (E. D. Pa. 1976). On that date, the defendant wrote the first of two opinion letters relevant to this case; the second was written on October 11, 1971.[3]

The jury found that the October 11 letter contained both material misrepresentations and material omissions, and that Herman Higgins, the defendant's employee who wrote the letter, acted either recklessly or with intent to defraud in preparing that letter. The jury also found that the July 22 letter did not contain material misrepresentations or omissions. We therefore stated, in our September 27, 1978 opinion, although this matter was not briefed or raised, that "liability can arise only from reliance on the October 11 letter." 457 F. Supp. at 884. The plaintiffs have now argued, and we are persuaded, that those investors who purchased their securities *after* October 11, 1971 in reliance on *either* opinion letter may pursue their claims for damages. Careful analysis of the evidence presented at trial and of the jury's verdict compels this decision.

The plaintiffs' evidence, offered to prove that *both* opinion letters were fraudulent, fell into three categories. *First*, the plaintiffs offered expert testimony that the letters were written recklessly because they failed to state certain material facts concerning the non-recourse loan which the letter assumed lending institutions would make to Westland Minerals Corporation (WMC), the general partner and promoter of the venture in which the plaintiffs had invested. *Second*, the plaintiffs introduced evidence which showed that by October 11, 1971, Higgins had acquired certain knowledge of a fraudulent loan scheme entered into by WMC. The plaintiffs' expert testified that if Higgins had written the opinion letters with this knowledge, then they contained a number of ma-

3. The letters are appended to this opinion.

terial misrepresentations. *Third*, the plaintiffs established that by October 11, 1971, Higgins was working closely with Economic Concepts, Inc. (ECI), the selling agent for WMC. According to the plaintiffs' expert, Higgins' failure to disclose this relationship in his tax opinion letters was a material omission.

There is no question that the October 11 letter is nearly a verbatim copy of the July 22 letter, with the addition of two final paragraphs not relevant to the fraud which was perpetrated in this case. Thus, it is clear that the jury's finding that the October 11 letter contained material misrepresentations and omissions could not have been based on the first category of evidence (*see supra*), for *both* letters were identical in this respect. Therefore, the only rational explanation for the jury's verdict is that it was based upon the evidence concerning Higgins' knowledge of WMC's fraud and his connection with ECI, and that the jury found that Higgins acquired this knowledge and began working for ECI *after* July 22 but before October 11. In essence, the jury's verdict represents a finding that the July 22 letter did not contain material misrepresentations or omissions *when written*, but that the *same letter* became fraudulent by October 11 due to information acquired by the author between those two dates.[4] In other words, the requisite scienter for § 10(b) liability was missing on July 22, but was acquired by October 11.

The plaintiffs argue that reliance by an investor on the July 22 letter after October 11 should create liability, for after the latter date the author of the July 22 letter either knew it to be false or acted in reckless disregard of the truth. Given such knowledge, or reckless conduct,

4. The liability of the defendant is based upon *respondeat superior* and upon its status as a "controlling person" under § 20(a) of the Securities Exchange Act.

the author (and therefore the defendant) should be liable for a breach of the duty to correct, after October 11, what had *become* a fraudulent opinion letter. This duty to correct a previously truthful but now fraudulent opinion arises from § 10(b) of the Securities Exchange Act of 1934, 15 U. S. C. § 78j(b), and SEC Rule 10b-5, 17 C. F. R. § 240.10b-5. The purpose of that statute, and the Rule promulgated thereunder, is to protect purchasers and sellers of securities from "*any* device, scheme, or artifice to defraud . . ." Rule 10b-5(a) (emphasis added). As has been recognized, "[f]raud may be accomplished [not only] by false statements, [but also by] a failure to correct a misleading impression left by statements already made . . . ." *Cochran v. Channing Corp.*, 211 F. Supp. 239, 243 (S. D. N. Y. 1962).

The duty to correct a previously truthful but now false opinion was recognized in *Thomas v. Duralite Company, Inc.*, 386 F. Supp. 698 (D. N. J. 1974), *aff'd as to liability, rev'd and remanded as to damages*, 524 F. 2d 577 (3d Cir. 1975). In imposing 10b-5 liability, the district court in that case stated that

> "The simple fact is that Thomas was induced by Lesser in January of 1968 to believe that his stock in Duralite was worthless, and worse still, that Thomas' position in Duralite had been transformed into a holding which, by reason of his personal loan and his company's (Edco.) indebtedness, could be momentarily translated into a liability. This information, the evidence indicates, was accurate and truthful when Lesser gave it in January of 1968. It certainly was *no longer accurate* when Lesser, Thomas and Edwards met in April, and as of June 18, 1968, when the contract of sale was made, it was totally false. Yet Thomas sold his stock on the basis of the representation that Duralite still hovered

> on the edge of bankruptcy, and Lesser *stood by silently and let him do so.*"

386 F. Supp. at 715 (emphasis added).[5]

Similarly, on our case, the defendant's July 22 opinion, though truthful when made, became materially misleading and therefore fraudulent sometime on or before October 11, due to knowledge acquired by the author after July 22. The failure by the author, and thus the defendant, to correct the impression given by the July 22 letter renders the defendant liable to those who invested after October 11 (the date the duty to correct arose) in reliance on the July 22 letter.

The defendant does not dispute the plaintiffs' contention that the two letters are materially identical or that it violated its duty to correct the original letter once it was rendered fraudulent. Rather, it maintains that the plaintiffs' argument in favor of allowing those who relied on the July 22 letter after October 11 to recover damages is in reality an untimely motion for judgment n. o. v. We disagree; what the plaintiffs are now seeking from us in a ruling *in accordance* with the verdict. The above discussion of the verdict is the only rational explanation of the jury's distinction between two materially identical letters. The plaintiffs have not asked us to hold, nor do we now hold, that the July 22 letter, when written, contained material misrepresentations and/or omissions. Such a holding *would* be one not in accordance with the

5. *Cf. United States v. Natelli*, 527 F. 2d 311, 319 (2d Cir. 1975), *cert. denied*, 425 U. S. 934, 96 S. Ct. 1663, 48 L. Ed. 2d 175 (1976) (holding that under § 32(a) of the Securities Exchange Act of 1934, 15 U. S. C. § 78ff(a), an accountant "has a duty to correct [an] earlier financial statement which he had audited himself and upon which he had issued his certificate, when he discovers 'that the figures in the annual report were substantially false and misleading,' and he has a chance to correct them.")

jury verdict, and prohibited as an untimely grant of judgment n. o. v. What we do now hold, however, is that the July 22 letter, although truthful when issued, became, according to the jury's verdict, fraudulent not later than October 11, and was unquestionably left uncorrected by the defendant. Therefore, any investor who purchased his or her limited partnership interest after October 11, 1971 in reliance on *either* the July 22 or October 11 opinion letter is now entitled to pursue his or her individual claim for damages.

II. The Measure of Damages

The fraud in this case consisted of the defendant's misrepresentations (and omissions) concerning the availability to investors of what we shall refer to, for simplicity's sake, as a "double tax deduction". According to the defendant's opinion letters, investors who purchased the limited partnership interests involved in this case could deduct from the income reported on their tax returns not only the amount of their investment but an additional and approximately equal sum representing the non-recourse loan which the defendant assumed that the drilling company would obtain from a lending institution.[6] However, for reasons explained in our September 27, 1978 opinion, this loan was not obtained by the drilling company and the double deduction could not properly be taken. Therefore, some or all of the plaintiffs who took this double deduction and who were audited by the I. R. S. had their deductions disallowed and were required to pay additional taxes.

The plaintiffs contend, however, that their damages were not limited to, nor should they be measured by, the extent of their tax problems. Rather, they argue that

6. Thus, for example, taxpayers in the 50% bracket would pay nothing for their investments, since their tax savings would be equivalent to the cost of the purchased security.

because of the defendant's fraud they purchased an investment described as having value as a double tax deduction, but which, in reality, lacked this value. Thus, the investment purchased was worth less than what the plaintiffs paid for it; it had value only as a speculative investment and as a "single" tax deduction.[7] The plaintiffs therefore argue that we should adopt an "out-of-pocket" measure of damages, allowing them to recover the difference between the price they paid for their investment and what it was actually worth at the time of purchase. The out-of-pocket method is in fact the traditional method employed in securities fraud cases for calculating damages,[8] and we shall adopt it here.[9]

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7. Investors could properly deduct the cost of their investment.

8. *See* Jacobs, *The Measure of Damages in Rule 10b-5 Cases*, 65 Georgetown L. J. 1093 (1977). In the case of a defrauded buyer, the out-of-pocket method permits the buyer to "recover the fair value of the consideration he paid for the security minus the fair value of the security he received, . . . measured at the time of the transaction." *Id.* at 1099. The Supreme Court and the Third Circuit Court of Appeals have adopted the out-of-pocket measure of damages in cases involving defrauded sellers. *Affiliated Ute Citizens v. United States*, 406 U. S. 128, 92 S. Ct. 1456, 31 L. Ed. 2d 741 (1972); *Thomas v. Duralite Company, Inc.*, 524 F. 2d 577 (3d Cir. 1975). In those cases, the courts defined the out-of-pocket measure of damages as permitting a defrauded seller to recover the "difference between the fair value of all that [he or she] received and the fair value of what he [or she] would have received had there been no fraudulent conduct . . . ." 406 U. S. at 155, 92 S. Ct. at 1473. This is of course the converse of the measure in cases such as ours involving defrauded buyers.

9. Whether the investment was actually worth less than what the plaintiffs paid for it, and how much less it was worth, are questions for the jury. If the plaintiffs cannot prove their out-of-pocket losses, they will of course not recover. But we believe that they are entitled to proceed according to their claims as to how much damage they have suffered.

The defendant, while not suggesting a specific method for measuring damages, objects to our adoption of the out-of-pocket rule, and would have the measure of damages tied to the tax consequences of the investments. The defendant argues that the plaintiffs who relied on its letters and purchased their investments in order to obtain a tax shelter were damaged only in the amount of the additional taxes they had to pay as a result of I. R. S. audits. It follows from this reasoning that those plaintiffs who were not audited by the I. R. S. "got what they paid for" (a double tax deduction), and suffered no damages. At least two problems arise from allowing the motive for the investment to determine the measure of damages.

First, any link between the measure of damages and the motive for the investment would be based upon a "benefit of the bargain" theory which, while appropriate in a contracts case, has no place in this securities fraud litigation. The plaintiffs did not have an agreement with the defendant pursuant to which the defendant would provide them with a double tax deduction; rather, because of the defendant's fraud, those plaintiffs who relied on the defendant's letters were induced to purchase an investment for a particular amount when in fact it was worth less than that amount (assuming the plaintiffs are correct). Such securities frauds have been likened to the common law tort of deceit, and, indeed, the use in § 10(b) cases of the out-of-pocket measure of damages has been borrowed from deceit actions. *Harris v. American Investment Co.*, 523 F. 2d 220, 224-225 (8th Cir. 1975), *cert. denied*, 423 U. S. 1054, 96 S. Ct. 784, 46 L. Ed. 2d 643 (1976).[10] Thus, in securities fraud cases, actual

10. *Harris* quotes the out-of-pocket rule set forth in § 549 of the Restatement of Torts (1938). A more recent version of § 549 calculates out-of-pocket damages as "(a) the difference between the value of what [the recipient of a fraudulent misrepresentation] has received in the transaction and its purchase price or other

"pecuniary loss rather than loss of bargain is the measure of damages . . . ." *Harris*, 523 F. 2d at 225.

A second reason for not using the tax consequences of the investment in order to measure the plaintiffs' damages is that such a measure would not make the plaintiffs whole. Although this procedure would allow the plaintiffs to recover the additional taxes which they paid, it would not compensate them for the loss, if any, caused by their purchase of a security worth less than what they paid for it. For these reasons, then, we believe that the out-of-pocket method is the appropriate one for calculating the damages sustained by the plaintiffs in this case.

III. Discovery

Having decided the above preliminary matters, we may now turn to the defendant's motion to compel answers to interrogatories and production of documents. We shall first consider the plaintiff's general objections to the defendant's instructions, and then the specific interrogatories and document requests to which the plaintiffs have objected. These interrogatories and requests are printed in the footnote accompanying the applicable discussion.

A. Plaintiffs' General Objections to Defendant's Instructions

The defendant has asked the individual members of the plaintiff class to answer the interrogatories on the forms it has provided and in the space following each question. The plaintiffs have surprisingly and unfortunately chosen to make a federal case out of such a trivial matter, and have argued that the Federal Rules do not require a party to submit answers to interrogatories on forms provided by

10. (Cont'd.)
value given for it . . . ." Restatement (Second) of Torts § 549 (1)(a) (1977).

his or her adversary. Therefore, say the plaintiffs, they will answer the interrogatories on separate sheets of paper.

The plaintiffs are correct in their literal reading of the discovery rules. However, the defendant's request is a salutary one and will contribute to the manageability of discovery involving over 200 parties. The convenience of having answers to interrogatories written immediately after the questions is obvious and will inure to the benefit of the court as well as the parties, should the answers be submitted in evidence at the trial. Therefore, pursuant to our general power under F. R. Civ. P. 23(d) to control the procedural aspects of a class action and to prevent the undue complication of that action, we will order the plaintiffs to answer the interrogatories on the defendant's forms.

The plaintiffs have also objected to the defendant's instruction that each class member sign the Request for Production of Documents. We will sustain this objection. Plaintiffs' counsel maintain that they already possess many of the requested documents, and we believe that it would be more efficient and far less complicated for counsel to obtain the remaining documents from the class members and then make them available to the defendant.

B. Interrogatory 1(c) [11]

The defendant contends that the information sought by this interrogatory is relevant to the issue of due diligence and the statute of limitations defense because an investor's occupation may reveal his or her financial and business sophistication and may reveal that he or she knew of the government investigation of the fraud involving the

11. "1. Give the following information:

(c) Your present occupation and your occupation (if different from your present occupation) when you purchased your interest in the 1971 WMC Ohio Producers Limited Partnerships."

1971 WMC Ohio Producers Limited Partnerships. The plaintiffs dispute the relevance of an investor's *present* occupation, but we believe that it may conceivably be relevant to the information the defendant is seeking and might shed light upon an investor's background, knowledge, etc. We will therefore overrule the plaintiff's objections to this interrogatory.

C. Interrogatory 3 [including redrafted Interrogatory 3(f)] [12]

The defendant claims that certain plaintiffs may have purchased their interests in the 1971 Ohio Producers Lim-

12. "3. If you invested in any other investments (e.g., Moray Producers 1969, 1970 and 1971 Programs, Fairdale-1971 Ohio Producers, Clintco Producers 1971) offered by Westland Minerals Corporation ("WMC"), Economic Concepts, Inc. ("ECI"), or any company or individual associated with WMC or ECI, give the following information:

(a) The date or dates on which you purchased your interest(s):

(b) The amount and name of each interest(s) (e.g., one-eighth interest in the Foley Well):

(c) The number of such interests:

(d) The purchase price of each interest:

(e) The form of payment (e.g., cash, cash and note):

(f)(i) Any other amounts including sales fees or sales commissions paid for or in respect of such interest(s):

(ii) Any attorneys' or accountants' fees paid for by you in connection with your interest(s):

(iii) Any other expenses incurred by you in connection with your interest(s):

(g) If any of your interest(s) in one well were transferred by Westland Minerals Corporation to another well, the dates of the transfer:

(h) The amount and name of any such transfer interest."

ited Partnerships *not* in reliance on the defendant's opinion letters, but because of prior successful investments in other WMC and/or ECI offerings. The defendant is correct that such an argument could be used to prove non-reliance, but not all of the information sought by Interrogatory 3 is relevant to this argument. Specifically, the information sought by Interrogatories 3(d)-(h) is not relevant to an identification of a plaintiff's interests in such other investments or the amount of production payments he or she may have received from those investments.

However, Interrogatories 3(g) and (h) are relevant in identifying those investors who obtained the partnership interests at issue in this litigation *not* by purchase but through transfer of other WMC investments. Investors who obtained their interests in this manner would not have relied on the defendant's opinion letters, and therefore this information is relevant to proving non-reliance. We will therefore sustain only the plaintiffs' objections to questions 3(d)-(f).

We agree with the plaintiffs that each investor's resonse should be limited to investments offered by WMC, ECI, and companies and/or individuals known by the investor, either at the time of purchase of the investment or at a later time, to be associated with WMC or ECI. If the investor does not know of such an association, then it would be impossible for him or her to answer this interrogatory as written.

D. Interrogatory 4 [13]

The information sought by this interrogatory is relevant to the issue of reliance and may disclose a plaintiff's

13. "4. With respect to each person with whom you had any communications (whether in writing or orally) concerning your decision to invest in the Ohio Partnerships or any other investment offered or sold by Westland Minerals Corporation ("WMC"),

motivation for purchasing the investment at issue in this litigation. Answers to the interrogatory may also reveal a plaintiff's reasons for purchasing interests in earlier WMC and/or ECI ventures, which could conceivably shed light upon his or her decision to purchase the 1971 investments. We will therefore overrule the plaintiffs' objection to this interrogatory. As with Interrogatory 3, however, we will limit the answers to investments offered or sold by WMC, ECI, and companies and individuals known by the investor at the time of purchase, or later, to be associated with WMC and/or ECI.

E. Interrogatories 5(a) and (c) [14]

The defendant argues that the information sought by these interrogatories is relevant to the statute of limitations defense and to the tolling of the statute of limitations, and that it may establish a date by which a reasonably diligent investor should have learned that his or her investment was in jeopardy. While it is the fraud of the defendant and not of WMC which is pertinent to this case, the evidence adduced at trial established certain connections between WMC and the defendant's employee Herman Hig-

13. (Cont'd.)

Economic Concepts, Inc. ("ECI"), or any company or individual associated with WMC or ECI, give the following information:

(a) The identity of the person(s) with whom you had the communications:

(b) The dates of such communications."

14. "5. With respect to your payment(s) for your investment(s), give the following information:

(a) The manner, if known to you, in which the amounts paid by you were used by the Ohio Partnerships:

(c) What communications, if any, you had with representatives of the Ohio Partnerships, WMC, ECI or any other person, concerning your payments and applications for funds for drilling."

gins, evidence which, as discussed above, clearly played a role in the jury's verdict. It is therefore conceivable that the information sought by these interrogatories is relevant or could lead to the discovery of relevant evidence, and we will order that the interrogatories be answered.

F. Interrogatories 8 and 9 [15]

These interrogatories seek the tax consequences of the plaintiffs' investments. The defendant's main argument in support of its motion to compel answers to these interrogatories is that the information sought by them is relevant to the measure of damages. However, our adoption of the out-of-pocket measure of damages makes the tax consequences of the investments irrelevant to the calcula-

15. "8. With respect to the tax treatment taken by you with respect to your investment in the Ohio Partnerships, give the following information:

(a) Whether you added or deducted any amount to or from your federal, state or local income tax returns in respect of your investment:

(b) The dates of such returns:

(c) The amounts added or deducted:

(d) The nature of the additions or deductions."

"9. With respect to audits or other actions taken by taxing authorities concerning your investment in and/or deductions for the Ohio Partnerships, state:

(a) Whether any of your additions or deductions have [sic] been questioned or have resulted in assessments or other action by any taxing authorities:

(b) Give the dates of any such questions, assessments or other action:

(c) The identity of the taxing authority which asked questions, made such assessments, or took such other action:

(d) The nature of such questions, assessments or actions:

(e) The disposition of such questions, assessments or actions."

tion of damages caused by the plaintiffs' purchase of the securities. However, at oral argument on February 2, 1979, the plaintiffs suggested that they might pursue claims for consequential expenses (such as accountant's and attorney's fees) which they incurred as a result of the auditing of their tax returns. If the plaintiffs do pursue such claims, the information sought by these interrogatories would be relevant.

Also, whether an investor took a double tax deduction for his or her investment is relevant to the issue of reliance. In the unlikely event that an investor did not take this deduction, failure to do so would rebut his or her claimed reliance on the defendant's opinion letters.

For these reasons we will overrule the plaintiffs' objections to these interrogatories.

G. Interrogatory 10 [16]

The plaintiffs object to this interrogatory to the extent that it calls for the identification of documents relating to those interrogatories to which their objections have been sustained. This is a valid objection, and we will therefore compel answers to Interrogatory 10 only as to those interrogatories to which we have overruled the plaintiffs' objections.

H. Document Request 1 [17]

The plaintiffs' objection to this document request is the same as their objection to Interrogatory 10, *supra*, and will necessarily be sustained as to those interrogatories to which their objections were also sustained.

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16. "10. Identify all documents which refer, relate to, concern or contain any of the information sought in each of the foregoing Interrogatories."

17. "1. All documents identified in response to Interrogatory 10 of Defendant's Interrogatories to Individual Members of the Plaintiff Class."

I. Document Request 3 [18]

We will overrule the plaintiffs' objections to this document request since material received by an investor concerning the partnership interests at issue in this case is obviously relevant to the issue of reliance. Also, material concerning other WMC or related ventures could have had some bearing on an investor's decision to purchase an interest in the 1971 WMC Ohio Producers Limited Partnerships.

J. Document Requests 4 and 11 [19]

The defendant claims that information in the requested documents may be relevant to determining the actual value of the plaintiffs' investments. We doubt that such information would be very helpful to this determination, since such factors as production payments are not

18. "3. All literature which you received from Westland Minerals Corporation, Economic Concepts, Inc., Commercial Property Funding Group, Inc., or any employee or individual connected with any of these companies concerning the description of or sale of limited partnership interests in (a) the 1971 WMC Ohio Producers Limited Partnerships, (b) the Moray Producers 1969, 1970 or 1971 Programs, (c) Fairdale—1971 Ohio Producers, (d) Clintco Producers 1971, or (e) any other investments offered by Westland Minerals Corporation or related companies."

19. "4. All correspondence between you and Westland Minerals Corporation, Economic Concepts, Inc., Commercial Property Funding Group, Inc., Hays and Company, Lea Carroll, or any other company or individual concerning the progress or status of the drilling or production of the wells in the 1971 WMC Ohio Producers Limited Partnerships, including correspondence relating to leasehold titles, solicitations for contributions to litigation funds and claims asserted by creditors in any state or federal court action."

"11. All correspondence and other communications with any persons (excluding attorneys) purporting to represent any individual member of the Plaintiff Class or the Plaintiff Class itself."

relevant to the value of the speculative investment in the wells *at the time of purchase.* Nevertheless, since information concerning the leaseholds could conceivably shed light upon the value of the investment, we will overrule the objection to Request 4.

Information sought by Request 4, and by Request 11, may also be relevant to the statute of limitations and tolling issues, since, as with answers to Interrogatory 5, *supra,* it may establish a date by which an investor knew or should have known that his or her investment was in jeopardy. We will therefore also overrule the plaintiffs' objection to Request 11.

K. Document Requests 5 and 6.[20]

As our discussion concerning Interrogatories 8 and 9 reveals, certain information concerning the tax consequences of the plaintiffs' investments is or could be relevant to this litigation. Also, an investor's 1971 tax return could reveal information relevant to the issue of reliance, since, for example, an investor in a comparatively "low" tax bracket might not have needed the type of tax shelter the defendant's opinion letters represented these investments to be.

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20. "5. All federal individual income tax returns (or any other tax returns) showing (a) any deductions taken by you for the 'loss' portion of your investment in the 1971 WMC Ohio Producers Limited Partnerships, (b) any production payments or other income received in any year by you from such investment, and (c) any adjustments which you made as a result of any audits of your investment in the 1971 WMC Ohio Producers Limited Partnerships."

"6. Correspondence with the Internal Revenue Service concerning your 'loss' deduction, including audit notices, adjustment notices, waivers of statutes of limitations, and petitions for review which you may have filed, in connection with the 1971 WMC Producers Limited Partnerships."

In deciding whether to require the production of the tax returns sought by this request, we must strike a balance between two competing public policies: that favoring the confidentiality of tax returns and that favoring liberal discovery. *See Cooper v. Hallgarten & Co.*, 34 F. R. D. 482 (S. D. N. Y. 1964). In our case, certain tax information is specifically relevant or could be relevant to this case, and while the information may be obtained through interrogatories, we do not believe that the defendant should be required to rely on answers to interrogatories when undeniably correct documentary evidence in the form of tax returns is available. This is not to suggest that any plaintiff would deliberately misrepresent his or her tax history, but merely recognizes that many taxpayers, confronted by an increasingly complex and turgid internal revenue code, delegate the preparation of their tax returns to accountants and sign them after only minimal scrutiny. We will therefore overrule the plaintiffs' objections to these requests.

L. Document Request 8.[21]

We will order that the plantiffs comply with this request only as it relates to the investment at issue in this case, the 1971 WMC Ohio Producers Limited Partnerships. The requested checks or money orders will conclusively establish which plaintiffs purchased these investments. However, we will sustain the plaintiffs' objections as to the other investments, since the amount and form of payments in other WMC and/or ECI investments are irrelevant.

21. "8. Checks or money orders issued by you to Westland Minerals Corporation, Economic Concepts, Inc., or any other company or broker-dealer for investments made by you in the 1971 WMC Ohio Producers Limited Partnerships or in any other venture operated or controlled by Westland Minerals Corporation or Economic Concepts, Inc."

IV. Procedure for Trying Damage Claims

The plaintiffs have submitted various proposals for trying the individual claims for damages. Since the defendant has not yet had an opportunity to conduct discovery with respect to damages or the other issues remaining to be tried, a decision by us at this time as to the appropriate method for trying damages would be premature.

APPENDIX

LYBRAND, ROSS BROS. & MONTGOMERY
Coopers & Lybrand
In Principal Areas
of the World
2 Broadway
New York, N. Y. 10004

July 22, 1971

Mr. Charles F. Raymond
Chairman of the Board
Westland Minerals Corporation
10642 Santa Monica Boulevard
Los Angeles, California 90025

Dear Mr. Raymond:

In accordance with your request, we have reviewed the Limited Partnership Agreement which will be used in your "1971 WMC Ohio Producers" Limited Partnerships and submit herewith our opinion, based solely on the facts contained therein and without verification by us, regarding the federal income tax consequences which can be anticipated by a limited partner in such a partnership.

Description of the Partnership Agreement

According to the Limited Partnership Agreement, the Limited Partner shall contribute $65,000 in cash to partnership capital and the General Partner, Westland Minerals Corporation, will contribute a specified lease upon which partnership activities will be conducted. In return

APFENDIX—Continued

for his contribution, 100% of partnership profits and losses shall be allocated to the Limited Partner until such time as he has received from operating income an amount equal to his initial $65,000 contribution; thereafter, partnership profits and losses shall be allocated seven-eighths to the Limited Partner and one-eighth to the General Partner.

The partnership will adopt the cash method of accounting and will, pursuant to Section 263(c) of the Internal Revenue Code of 1954, elect to deduct as expenses any costs which may be deducted under that Section.

Upon formation of the partnership, the General Partner on behalf of the partnership will enter into a drilling contract with Rayco, Inc. whereby Rayco will undertake to drill to completion a well upon the partnership property. Upon discovery of oil or gas in commercial quantities, Rayco will equip the well for production; or, if the drilling results in a dry hole, Rayco will take such steps as are necessary to plugging and abandoning the well in accordance with local regulations. We understand that drilling operations probably will not begin until sometime in the fourth quarter of 1971.

In payment for its obligations assumed under the aforementioned drilling contract, Rayco will receive upon execution of the drilling contract $140,000 in cash. The necessary cash will be provided from the Limited Partner's cash contribution of $65,000 and through partnership borrowing for the balance. Such borrowing will be from suitable banks or other lending agencies and will be without personal liability to the General Partner and the Limited Partner.

Based upon its past experience and upon expert geological opinions, Rayco has estimated that the $140,000 received under the drilling contract will be expended on the following basis:

APPENDIX—Continued

	Estimated Percentage of Total	*Estimated $ Amount*
Intangible Drilling Costs	91.5%	$128,000
Tangible Completion and Equipment Costs	8.5%	12,000
Totals	100%	$140,000

Opinion

As mentioned above, 100% of partnership profits and losses will be allocated to the Limited Partner until such time as he recovers his initial contribution to partnership capital out of operating income; thereafter, profits and losses shall be allocated on the basis of seven-eighths to the Limited Partner and one-eighth to the General Partner. Under Regulations 1.704-1(b)(2), such a disproportionate sharing of partnership profits and losses is permissible unless the avoidance of federal income tax is a principal purpose of the partnership agreement in this respect. Since disproportionate contributions of cash is normal in conducting drilling operations and is in accord with common practice in the industry, it seems clear that tax avoidance is not the principal purpose of the allocation. A similar position has been recognized by the Internal Revenue Service in Revenue Ruling 68-139, 1968-1 C. B. 311.

A Limited Partner's initial adjusted basis in the partnership will be equal to his capital contributions under Sections 705 and 722 of the Internal Revenue Code of

APPENDIX—Continued

1954. Section 752(a) of the Internal Revenue Code of 1954 provides that a partner's basis in his partnership interest shall be increased by his share of any partnership liabilities. Where no partner has any personal liability with respect to a partnership liability, Regulation 1.752-1(e), provides that all partners, including limited partners, shall be deemed to share such liability in the same proportion as partnership profits are shared.

Section 704(d) provides that a partner's deductions for his distributive share of partnership losses are limited to his adjusted basis in the partnership.

Under the above Code Sections and Regulations, the Limited Partner in the present case should receive an adjusted basis for his partnership interest which will equal his initial cash contribution plus the full amount of partnership debt incurred to finance the development of the partnership properties since, under the Partnership Agreement, 100% of profits and losses will be allocable to the Limited Partner when the debt is incurred. Thus the maximum limitation on the amount of partnership losses which can be claimed by the Limited Partner on his individual income tax return will be $140,000, comprised of his $65,000 cash contribution plus the $75,000 debt incurred under the drilling contract.

Since the partnership will adopt the cash method of accounting, any expenses contracted for and paid for during a taxable year must be taken into account on the Federal partnership return of income for that year. Regulations 1.461-1(a)(1). Each partner must deduct his distributive share of such expenses on his Federal income tax return for the taxable year in which he receives such distributive share. *Pauley v. U. S.*, 63-1 USTC para. 9280. *See* also Revenue Ruling 71-252 I. R. B. 1971-23, 17.

APPENDIX—Continued

In accordance with the above principles, it is our opinion that the portion of the amount paid upon executing the drilling contract which can be allocated to non-capital items under that contract will be deductible by the Limited Partner on his individual income tax return for the year in which such payment is made.

Amounts attributable to capital items such as tangible completion and equipment costs must be capitalized and recovered through depreciation deductions in subsequent years.

Since drilling operations probably will not commence until the fourth quarter of 1971, it does not appear that any significant amount of revenue from production operations can be expected to be available to reduce partnerships losses in calendar year 1971.

Accordingly, assuming that the estimated figures provided by Rayco as to allocation of proceeds are accurate, and that both the Partnership Agreement and the drilling contract are executed in calendar year 1971, a cash basis Limited Partner having a calendar taxable year should be entitled to claim a deduction of approximately $128,000 on his 1971 individual income tax return.

Very truly yours,

(s) Lybrand, Ross Bros. & Montgomery

FAG:ic

APPENDIX—Continued

LYBRAND, ROSS BROS. & MONTGOMERY

Coopers & Lybrand
In Principal Areas
of the World

2 Broadway
New York, N. Y. 10004

October 11, 1971

Mr. Charles F. Raymond
Chairman of the Board
Westland Minerals Corporation
10642 Santa Monica Boulevard
Los Angeles, California 90025

Dear Mr. Raymond:

In accordance with your request, we have reviewed the Limited Partnership Agreement which will be used in your "1971 WMC Ohio Producers" Limited Partnerships and submit herewith our opinion, based solely on the facts contained therein and without verification by us, regarding the federal income tax consequences which can be anticipated by a limited partner in such a partnership.

Description of the Partnership Agreement

According to the Limited Partnership Agreement, the Limited Partner shall contribute $65,000 in cash to partnership capital and the General Partner, Westland Minerals Corporation, will contribute a specified lease upon which partnership activities will be conducted. In return for his contribution, 100% of partnership profits and losses shall be allocated to the Limited Partner until such time

APPENDIX—Continued

as he has received from operating income an amount equal to his initial $65,000 contribution; thereafter, partnership profits and losses shall be allocated seven-eighths to the Limited Partner and one-eighth to the General Partner.

The partnership will adopt a calendar-year accounting period, the cash method of accounting and will, pursuant to Section 263(c) of the Internal Revenue Code of 1954, elect to deduct as expenses any costs which may be deducted under that Section.

Upon formation of the partnership, the General Partner on behalf of the partnership will enter into a drilling contract with Rayco, Inc. whereby Rayco will undertake to drill to completion a well upon the partnership property. Upon discovery of oil or gas in commercial quantities, Rayco will equip the well for production; or, if the drilling results in a dry hole, Rayco will take such steps as are necessary to plugging and abandoning the well in accordance with local regulations. We understand that drilling operations probably will not begin until sometime in the fourth quarter of 1971.

In payment for its obligations assumed under the aforementioned drilling contract, Rayco will receive upon execution of the drilling contract $140,000 in cash. The necessary cash will be provided from the Limited Partner's cash contribution of $65,000 and through partnership borrowing for the balance. Such borrowing will be from suitable banks or other lending agencies and will be without personal liability to the General Partner and the Limited Partner.

Based upon its past experience and upon expert geological opinions, Rayco has estimated that the $140,000 received under the drilling contract will be expended on the following basis:

APPENDIX—Continued

	Estimated Percentage of Total	*Estimated & Amount*
Intangible Drilling Costs	91.5%	$128,000
Tangible Competion and Equipment Costs	8.5%	12,000
Totals	100%	$140,000

Opinion

As mentioned above, 100% of partnership profits and losses will be allocated to the Limited Partner until such time as he recovers his initial contribution to partnership capital out of operating income; thereafter, profits and losses shall be allocated on the basis of seven-eighths to the Limited Partner and one-eighth to the General Partner. Under Regulations 1.704-1(b)(2), such a disproportionate sharing of partnership profits and losses is permissible unless the avoidance of federal income tax is a principal purpose of the partnership agreement in this respect. Since disproportionate contributions of cash are normal in conducting drilling operations and are in accord with common practice in the industry, it seems clear that tax avoidance is not the principal purpose of the allocation. A similar position has been recognized by the Internal Revenue Service in Revenue Ruling 68-139, 1968-1 C. B. 311.

A Limited Partner's initial adjusted basis in the partnership will be equal to his capital contributions under Sections 705 and 722 of the Internal Revenue Code of

APPENDIX—Continued

1954. Section 752(a) of the Internal Revenue Code of 1954 provides that a partner's basis in his partnership interest shall be increased by his share of any partnership liabilities. Where no partner has any personal liability with respect to a partnership liability, Regulation 1.752-1(e) provides that all partners, including limited partners, shall be deemed to share such liability in the same proportion as partnership profits are shared.

Section 704(d) provides that a partner's deductions for his distributive share of partnership losses are limited to his adjusted basis in the partnership.

Under the above Code Sections and Regulations, the Limited Partner in the present case should receive an adjusted basis for his partnership interest which will equal his initial cash contribution plus the full amount of partnership debt incurred to finance the development of the partnership properties since, under the Partnership Agreement, 100% of profits and losses will be allocable to the Limited Partner when the debt is incurred. Thus the maximum limitation on the amount of partnership losses which can be claimed by the Limited Partner on his individual income tax return will be $140,000, comprised of his $65,000 cash contribution plus the $75,000 debt incurred to finance payments under the drilling contract.

Since the partnership will adopt the cash method of accounting, any expenses contracted for and paid for during a taxable year, must be taken into account on the Federal partnership return of income for that year. Regulations 1.461-1(a)(1). Each partner must deduct his distributive share of such expenses on his Federal income tax return for the taxable year in which the taxable year of the partnership in which the expenses are paid ends. *Pauley v. U. S.* 63-1 USTC para. 9280. See also Revenue Ruling 71-252, I. R. B. 1971-23, 17.

APPENDIX—Continued

In accordance with the above principles, it is our opinion that the portion of the amount paid upon executing the drilling contract which can be allocated to non-capital items under that contract will be deductible by the Limited Partner on his individual income tax return for the year in which the partnership taxable year in which such payment is made ends.

Amounts attributable to capital items such as tangible completion and equipment costs must be capitalized and recovered through depreciation deductions in subsequent years.

Since drilling operations probably will not commence until the fourth quarter of 1971, it does not appear that any significant amount of revenue from production operations can be expected to be available to reduce partnership losses in calendar year 1971.

Accordingly, assuming that the estimated figures provided by Rayco as to allocation of proceeds are accurate, and that both the Partnership Agreement and the drilling contract are executed in calendar year 1971, a cash basis Limited Partner having a calendar taxable year should be entitled to claim a deduction of approximately $128,000 on his 1971 individual income tax return.

In the event that the partnership property is sold, the investor will recognize gain to the extent of his distributive share of any partnership gain on such sale. In computing such partnership gain, the proceeds of sale realized by the partnership are deemed to include the amount of any partnership obligations assumed by the purchaser. Since you have indicated that the venture will hold leases only for development purposes and not primarily for resale, most of any gain realized by the partnership from the sale of property held for more than six months should

APPENDIX—Continued

be considered gain from the sale of property used in the trade or business under Section 1231(b) of the Internal Revenue Code. See Revenue Ruling 68-226, 1968-1 C. B. 362. Such gain is usually treated as long-term capital gain, unless offset by certain losses as provided in Section 1231. Depreciation recapture, if any, is taxed as ordinary income.

If the property passes to a third party in accordance with the default provisions of any note or other obligation of the partnership, such foreclosure will be deemed to constitute a sale or exchange of such property under the principles set forth in *Rogers v. Commissioner,* 39-1 USTC para. 9490 (9th Cir. 1939) and *Lutz & Schramm Co.,* 1 T. C. 682. See also Revenue Ruling 67-188, 1967-1 C. B. 216. Accordingly, the partnership will realize a gain to the extent that the unpaid balance of the note exceeds the partnership's adjusted basis in the subject property. Under the principles espoused in the aforementioned *Rogers* case and in *Leland S. Collins,* 22 TCM 1467, it would appear that any disposition, either voluntary or involuntary, through transfer of the property to the holder of the note should not be regarded as forgiveness of indebtedness and, accordingly, should be treated as a sale or exchange of property used in the partnership's trade or business, and taxed, as discussed, above, under Section 1231.

Very truly yours,

(s) Lybrand, Ross Bros. & Montgomery

DTW:rm

UNITED STATES DISTRICT COURT,
E. D. PENNSYLVANIA

Stanley L. SHARP

v.

COOPERS & LYBRAND

Civ. A. No. 75-1313.

June 11, 1980.

JOSEPH S. LORD, III, *Chief Judge.*

In this section 10(b) securities fraud class action suit, juries have found the defendant accounting firm liable for material misrepresentations and omissions in an opinion letter used as a selling device for oil well investments,[1] and have assessed the worth of the oil wells at the time of purchase in 1971.[2] Three post trial matters must be resolved in order to mold the verdicts for plaintiffs Stanley Sharp, H. James Conaway, Jr., and Sam Geftic in accordance with the jury's findings: the appropriateness of an award of prejudgment interest, the effect of the availability of a single tax deduction on the damage award, and the amount of James Conaway's damages.

1. The first jury trial took place from February 27 through March 10, 1978. Opinion on post trial motions is reported in *Sharp v. Coopers & Lybrand*, 457 F. Supp. 879 (E. D. Pa. 1978).

2. The second jury trial took place from May 12 through May 19, 1980. In addition to assessing the value of the purchase, the jury answered special interrogatories finding reliance and due diligence on the part of plaintiffs, and that the suit was brought within the applicable statute of limitations period. With regard to the actual value of the investment, the jury found that a one-eighth limited partnership interest in the 1971 WMC Ohio Producers Program as of late December, 1971, was $1240. Interrogatory No. 4, May 19, 1980.

1. Prejudgment Interest

In tort actions as a general rule prejudgment interest is not awarded on unliquidated claims, but, even when damages to be recovered are unliquidated, interest may be awarded when in the trial court's discretion fair compensation requires it. *E.g., Rea v. Ford Motor Co.*, 560 F. 2d 554, 558 (3d Cir.), *cert. denied*, 434 U. S. 923, 98 S. Ct. 401, 54 L. Ed. 2d 281 (1977); *Sun Shipbuilding & Drydock Co. v. United States Lines, Inc.*, 439 F. Supp. 671 (E. D. Pa. 1977), *aff'd*, 582 F. 2d 1276 (3d Cir. 1978), *cert. denied*, 439 U. S. 1073, 99 S. Ct. 846, 59 L. Ed. 2d 40 (1979).

In securities actions, the award of prejudgment interest does not generally turn on the characterization of the damages as liquidated or unliquidated,[3] but rather is a matter of discretion for the trial court and is determined by a standard of fairness. *Blau v. Lehman*, 368 U. S. 403, 414, 82 S. Ct. 451, 457, 7 L. Ed. 2d 403 (1962); *Gould v. American-Hawaiian S. S. Co.*, 535 F. 2d 761, 784-85 (3d Cir. 1976); *Wolf v. Frank*, 477 F. 2d 467, 479 (5th Cir.), *cert. denied*, 414 U. S. 975, 94 S. Ct. 287, 38 L. Ed. 2d 218 (1973).[4]

In an earlier decision I determined that the appropriate measure of damages in this § 10(b) case was the out-of-pocket measurement, i.e., "the difference between

3. *Compare Nye v. Blyth Eastman Dillon & Co.*, 588 F. 2d 1189, 1200 (8th Cir. 1978) where in a securities case the Court of Appeals found no abuse of discretion in the trial court's conclusion that no interest should be awarded on damages that were unliquidated and could not be easily measured by a known standard. This conclusion was stated in one sentence with no explanation or elaboration.

4. Whether the damages can be readily ascertained in a securities action may be of importance in determining the fairness of assessing prejudgment interest.

the price [the plaintiffs] paid for their investment and what it was actually worth at the time of purchase." *Sharp v. Coopers & Lybrand*, 83 F. R. D. 343, 347 (E. D. Pa. 1979). In the case of a defrauded buyer, as here, the First Circuit in a frequently cited opinion has held that "[D]amages are to be reckoned solely by 'the difference between the real value of the property at the date of its sale to the plaintiffs and the price paid for it, with interest *from that date . . .*'" *Janigan v. Taylor*, 344 F. 2d 781, 786 (1st Cir.), *cert. denied*, 382 U. S. 879, 86 S. Ct. 163, 15 L. Ed. 2d 120 (1965) *quoting Sigafus v. Porter*, 179 U. S. 116, 125, 21 S. Ct. 34, 37, 45 L. Ed. 113 (1900) (emphasis added); *Estate Counseling Service, Inc. v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 303 F. 2d 527, 533 (10th Cir. 1962). In *Sigafus*, the Supreme Court discussed earlier cases that applied this damage standard to claims of fraudulent misrepresentation whereby plaintiffs were induced to buy shares. Without so denominating the issue as one of liquidated or unliquidated damages, the analysis underlying these cases is the functional equivalent of a determination that the damages to be recovered are liquidated. As applied to this case, the reasoning would be that plaintiffs advanced a sum certain ($8,125 for a one-eighth limited partnership interest) and received something worth less than they had been told to expect. The plaintiffs were thus deprived of the use of that sum (by definition an ascertainable amount), and proper compensation should include interest from the date of purchase.[5]

5. Unlike this case, in *Gould* the court stated that the damage award was to redress a violation of § 14(a) by a materially deficient proxy statement and letter, and not "to make the plaintiffs whole for funds to which they were legally entitled . . . ." 535 F. 2d at 785. In *Sharp* the § 10(b) violation caused plaintiffs to part with a sum certain for a security fraudulently represented as

In later securities cases, courts have used two different dates for the assessment of damages, some holding that it is the date of purchase; others, the date of discovery of the fraud or when the plaintiff reasonably should have discovered the fraud, *i.e.*, the date the cause of action accrued. *See Harris v. American Investment Co.*, 523 F. 2d 220, 225-27 (8th Cir. 1975), *cert. denied*, 423 U. S. 1054, 96 S. Ct. 784, 46 L. Ed. 2d 643 (1976) and the cases cited therein. Here, the date of purchase is the proper measure, since the interest in the well was not a traded security whose value fluctuated with the vicissitudes of the market. Rather, the actual value of the security in 1971 is measured by the anticipated return in gas and oil on a representative well in the 1971 WMC Ohio Program over the life of the well. I thus conclude that prejudgment interest from the date of purchase would be appropriate compensation in this case. The remaining question is whether as a matter of fairness interest should be awarded. *Thomas v. Duralite Co.*, 524 F. 2d 577, 589 (3d Cir. 1975) ("Interest is not to be recovered merely as compensation for money withheld but, rather, in response to considerations of fairness.")

In *Norte & Co. v. Huffines*, 416 F. 2d 1189 (2d Cir. 1969), *cert. denied sub nom., Muscat v. Norte & Co.*, 397 U. S. 989, 90 S. Ct. 1121, 25 L. Ed. 2d 396 (1970), the Second Circuit outlined the factors to be considered in addition to fundamental considerations of fairness in determining whether prejudgment interest should be awarded:

1) degree of personal wrongdoing;

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5. (Cont'd.)

having a value it did not have. The damage award is compensatory and is indeed designed to make plaintiffs whole for funds they would not have parted with had there been no fraud as perpetrated by the defendant in its opinion letter.

2) whether such interest would be truly compensatory;

3) the availability of alternative investment opportunities to the plaintiff;

4) the length and reason for the time gap between the violation and award of judgment.

See also, Fox v. Kane-Miller Corp., 398 F. Supp. 609 (D. Md. 1975), *aff'd in part and remanded on other grounds*, 542 F. 2d 915 (4th Cir. 1976).

First, in the 1978 *Sharp* trial, the jury found that the defendant's employee had perpetrated a fraud with intent or recklessness and that the defendant was responsible for its employee's actions. In the post trial opinion I found that the defendant was or should have been aware that the opinion letter would be disseminated to potential purchasers. *Sharp*, 457 F. Supp. at 887. Indeed in the second trial the jury found that the plaintiffs would not have purchased their investments had it not been for the fraud perpetrated in the defendant's opinion letter.

Second, an award of interest here would be compensatory because each plaintiff was "deprived" of a principal sum ($8,125 for a one-eighth interest) at a clearly defined date (December 1971, the date of purchase), *Norte & Co., supra*, 416 F. 2d at 1192.

Third, as a result of the purchase of the securities, plaintiffs had a part interest in an oil well bought for a promised double deduction tax shelter that in fact offered only a single deduction. Plaintiffs were therefore left with a well and not a tax shelter, and the well's value was in the monetary return from gas and oil produced by it over its productive life. Thus the availability of alternative investment opportunities with the security they had purchased is not an applicable measurement in this case.

Fourth, the jury in the second trial found that the plaintiffs did not know nor reasonably should have known before May 7, 1974, of the defendant's fraud. The suit was brought May 8, 1975, and tried in 1978. There was no lengthy delay between knowledge and action on the basis of that knowledge. The time delay between filing of the complaint and the first trial was neither unduly lengthy nor attributable to either party. That is, the time gap was not intentionally prolonged by the plaintiff.

In sum, plaintiffs invested more than $8,000 for a one-eighth interest in an oil well in 1971 for legitimate tax shelter purposes, were defrauded as to the tax consequences and thereby lost the use of their investment money from the time of purchase.[6] To compensate the plaintiffs for this loss, I find an award of prejudgment interest in this case to meet the applicable standards of fairness.

2. *Single Tax Consequences*

The defendant asks that the damage verdict (based on the jury's answers to special interrogatories) be adjusted on the basis that the plaintiffs got a single tax deduction, even though not the double deduction as represented. After the first trial on liability, I determined that for the second trial on damages the out-of-pocket rule was the appropriate measure of damages. *Sharp*, 83 F. R. D. at 348. In that opinion I specifically rejected a theory of damages based on the tax consequences of the plaintiffs' purchases for reasons unnecessary to repeat now. *Id.* at 347-48. That determination is the law of the case and precludes granting of the defendant's request to consider the tax consequences of the purchase in molding the damage verdict.

6. As noted above, the jury in the second trial found that the plaintiffs would not have purchased the security had they known of the material misrepresentations and omissions in the defendant's opinion letter, *i.e.*, that there was no double tax deduction for the purchase.

3. *Conaway's Damages*

Plaintiffs sued for the amount they invested minus the actual value of what they got. In the second trial, the jury determined that the actual value of a one-eighth interest was $1,240, which is an expert's estimate of what a representative well in the 1971 WMC Ohio Program would have yielded over its life span. The investment was a speculative one, and plaintiffs ran a risk of no return. In fact, plaintiffs Sharp and Geftic got no return on their wells. Nevertheless, the value in 1971 of the security they purchased could only be estimated, and thus that amount is subtracted from the sum they invested and the difference (plus interest) is their recoverable damage.

Unlike Sharp and Geftic, Conaway in fact got a $1,932 return on his investment. Since the measure of damages is the difference between actual value and price paid, Conaway's investment of $8,125 is to be reduced by $1,932 to arrive at his recoverable damages. Plaintiffs have advanced the argument that if $1,932 is to be subtracted from Conaway's award, since Sharp and Geftic got no return, nothing should be subtracted from their award. Although this would seem to be consistent with the rationale of Conaway's award, in fact it gives Sharp and Geftic a hindsight cushioning of what was only a speculative investment. Although the plaintiffs did not anticipate "speculating," as it were, on the tax consequences of the investment, once the fraud was perpetrated and relied on by the plaintiffs to their detriment, the plaintiffs were indeed left with a risk investment, *i.e.*, what they would get from their wells. That risk is to be measured by anticipated return, or an actual return *if there was one* as in Conaway's case. To do otherwise would turn Sharp's and Geftic's speculative investment into a no-loss risk, that is, no risk at all.

IN THE
UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

CIVIL ACTION NO. 75-1313

STANLEY L. SHARP

v.

COOPERS & LYBRAND

ORDER

AND NOW, this 19th day of February, 1976, upon consideration of plaintiff's motion for class action determination, it is ORDERED that this action shall proceed as a class action pursuant to the provisions of Rule 23 of the Federal Rules of Civil Procedure.

BY THE COURT

/s/ JOSEPH S. LORD, III
Joseph S. Lord, III
Chief Judge

IN THE
UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

CIVIL ACTION NO. 75-1313

STANLEY L. SHARP

v.

COOPERS AND LYBRAND

ORDER

AND NOW, this 17th day of March, 1978, judgment is entered as follows:

1. The jury's answers to interrogatories filed and docketed March 13, 1978 are entered as the judgment of the Court.

2. Judgment in favor of the defendant is entered on Count III of the Complaint.

3. The defendant is adjudged to have used the facilities of interstate commerce and the mails in connection with the purchase and sale of securities, namely, interests in the Limited Partnerships in Westland Minerals Corporation Ohio Producers 1971.

BY THE COURT

/s/ JOSEPH S. LORD, III
Joseph S. Lord, III
Chief Judge

IN THE
UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

CIVIL ACTION NO. 75-1313

STANLEY SHARP, et al.

v.

COOPERS & LYBRAND

ORDER

AND NOW, this 27th day of September, 1978, it is hereby ORDERED as follows:

1. That plaintiffs' motion to vacate the judgment entered for defendant as to Count Three be and it hereby is GRANTED;

2. That the plaintiffs' motion for judgment n.o.v. with respect to the jury's answer to interrogatory #11 be and it hereby is DENIED: and

3. That the defendant's motion for judgment in accordance with the verdict and for judgment n.o.v. as to Counts One and Two and for a new trial be and they hereby are DENIED.

/s/ JOSEPH S. LORD, III
Joseph S. Lord, III
Chief Judge

IN THE
UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

CIVIL ACTION NO. 75-1313

STANLEY L. SHARP, et al.

v.

COOPERS & LYBRAND

ORDER

AND NOW, this 26th day of June, 1979, it is hereby ORDERED that the motion of the defendant to compel answers to interrogatories and the production of documents is GRANTED as to: (a) Interrogatory 1(c); (b) Interrogatories 3(a), (b), (c), (g), and (h); (c) Interrogatory 4; (d) Interrogatories 5(a) and (c); (e) Interrogatories 8 and 9; (f) Interrogatory 10 (only with respect to the above-named interrogatories); (g) Document Request 1; (h) Document Request 3; (i) Document Requests 4 and 11; (j) Document Requests 5 and 6; (k) Document Request 8 (only with respect to investments in the 1971 WMC Ohio Producers Limited Partnerships).

IT IS ALSO ORDERED that the defendant's motion to compel the plaintiffs to answer the interrogatories on the defendant's forms is GRANTED and that the defendant's motion to compel each member of the plaintiff class to sign the Request for Production of Documents is DENIED.

/s/ JOSEPH S. LORD, III
Joseph S. Lord, III
Chief Judge

IN THE
UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

CIVIL ACTION NO. 75-1313

STANLEY L. SHARP

v.

COOPERS & LYBRAND

ORDER

AND NOW, this 11th day of June, 1980, the jury having answered special interrogatories on reliance, due diligence and statute of limitations issues in favor of plaintiffs Stanley L. Sharp, H. James Conaway, Jr. and Sam Geftic, and the jury having further determined that the actual value of a one-eighth interest in the 1971 WMC Ohio Program as of late December 1971 was $1,240, it is hereby

ORDERED that

1. Judgment is entered in favor of Stanley L. Sharp, H. James Conaway, Jr. and Sam Geftic on special interrogatories 1 through 4 and their claims that defendant violated §§ 10(b) and 20 of the Securities Exchange Act of 1934 and SEC Rule 10b-5.

2. Damages are assessed against the defendant in favor of

(a) Stanley L. Sharp in the amount of $6,885 plus interest from the date of purchase;

(b) In favor of H. James Conaway, Jr. in the amount of $6,193 plus interest from the date of purchase;

(c) In favor of Sam Geftic in the amount of $3,442.50 plus interest from the date of purchase.

3. Interest is to be rewarded to the plaintiffs at the rate of 6% per annum from December 31, 1971 to the date of satisfaction of the judgment.

4. Pursuant to Rule 54(b) of the Federal Rules of Civil Procedure this judgment shall be entered as a final judgment. I find that there is no just reason for delay in the entry of judgment. Certification under Rule 54(b) will not result in unnecessary appellate review, nor will any future developments in this case moot the review or need for review of these adjudicated claims. No claim or counterclaim that might result in a set-off of the judgment to be made final has been asserted. Certification under Rule 54(b) will promote the interests of sound judicial administration and justice to the litigants because it may shorten the time of trial and reduce the expense of litigation both to the parties and the federal court system.

/s/ JOSEPH S. LORD, III
Joseph S. Lord, III
Chief Judge

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 80-2229

SHARP, STANLEY L.

v.

COOPERS & LYBRAND,

Appellant

(D. C. CIVIL No. 75-01313)

ON APPEAL FROM THE UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

Present: ALDISERT and HIGGINBOTHAM, *Circuit Judges* and MARKEY, *Chief Judge* *

JUDGMENT

This cause came on to be heard on the record from the United States District Court for the Eastern District of Pennsylvania and was argued by counsel on March 19, 1981.

On consideration whereof, it is now here ordered and adjudged by this Court that the orders of the said District

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* Honorable Howard T. Markey, of the United States Court of Customs and Patent Appeals, sitting by designation.

Court, entered June 11, 1980 and July 11, 1980, be, and the same are hereby vacated with respect to the award of damages and the cause remanded to the said District Court for a new trial on that issue, and affirmed in all other respects, in accordance with the opinion of this Court. Each party shall bear its own costs.

ATTEST:

/s/ M. ELIZABETH FERGUSON
Chief Deputy Clerk

April 28, 1981

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 80-2229

SHARP, STANLEY L.

v.

COOPERS & LYBRAND,

Appellant

(E. D. PA. CIVIL No. 75-01313)

Present: ALDISERT and HIGGINBOTHAM, *Circuit Judges*, and MARKEY, *Chief Judge.**

ORDER

The petition for panel rehearing filed by appellee in the above entitled case having been submitted to the judges who participated in the decision of this court, and no judge who concurred in the decision having asked for rehearing, the petition for rehearing before the original panel is denied.

BY THE COURT,

/s/ ALDISERT
Circuit Judge

DATED: May 27, 1981

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* Honorable Howard T. Markey, of the United States Court of Customs and Patent Appeals, sitting by designation.

UNITED STATES COURT OF APPEALS
FOR THE THIRD CIRCUIT

No. 80-2229

SHARP, STANLEY L.

v.

COOPERS & LYBRAND,

Appellant

(E. D. PA. CIVIL NO. 75-01313)

SUR PETITION FOR REHEARING

Present: SEITZ, *Chief Judge*, and ALDISERT, ADAMS, GIBBONS, HUNTER, WEIS, GARTH, HIGGINBOTHAM and SLOVITER, *Circuit Judges*, and MARKEY, *Chief Judge*.*

The petition for rehearing filed by Appellant in the above entitled case having been submitted to the judges who participated in the decision of this court and to all the other available circuit judges of the circuit in regular active service, and no judge who concurred in the decision having asked for rehearing, and a majority of the circuit judges of the circuit in regular active service not having voted for rehearing by the court in banc, the petition for rehearing is denied.

BY THE COURT,

/s/ ALDISERT
Judge

DATED: June 5, 1981

* Honorable Howard T. Markey, of the United States Court of Customs and Patent Appeals, sitting by designation.

IN THE
UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

CIVIL ACTION NO. 75-1313

STANLEY L. SHARP

v.

COOPERS AND LYBRAND

INTERROGATORIES TO THE JURY

10(B)(5) CLAIM

1. Did the defendant in the July 22, 1971, letter, (Exhibit P-153) make:

(a) material misrepresentations:

YES _____ NO ×

(b) material omissions:

YES _____ NO ×

2. If you have answered either #1(a) or #1(b) or both "YES", do you find that any partner acting in the scope and course of his duties as a partner of defendant, caused with scienter, that is, intent to defraud or recklessness as I have defined it to you:

(a) the material misrepresentations:

YES _____ NO _____

(b) the material omissions:

YES _____ NO _____

3. If you have answered either #1(a) or #1(b) or both "YES", do you find that Herman Higgins, acting in the scope and course of his duties as an employee of defendant, caused with scienter, that is, intent to defraud or recklessness as I have defined it to you:

(a) the material misrepresentations:

YES _____ NO _____

(b) the material omissions:

YES _____ NO _____

4. Did the defendant in the October 11, 1971, letter (Exhibit P-103) make:

(a) material misrepresentations:

YES × NO _____

(b) material omissions:

YES × NO _____

5. If you have answered either #4(a) or #4(b) or both "YES", do you find that any partner, acting in the scope and course of his duties as a partner of defendant, caused with scienter, that is, intent to defraud or recklessness as I have defined it to you:

(a) the material misrepresentations:

YES _____ NO ×

(b) the material omissions:

YES _____ NO ×

6. If you have answered either #4(a) or #4(b) or both "YES", do you find that Herman Higgins, acting in the scope and course of his duties as an employee of defendant, caused with scienter, that is, intent to defraud or recklessness as I have defined it to you:

(a) the material misrepresentations:

YES × NO _____

(b) the material omissions:

YES × NO ____

SECTION 20(a)

7. If the answer to questions #3 or #6 is "YES", did the defendant directly or indirectly have the power to control the wrongful activities of Herman Higgins?

YES × NO ____

8. Did the defendant exercise good faith by exercising reasonably adequate and sufficient supervision over the activities of Herman Higgins?

YES ____ NO ×

COMMON LAW FRAUD

9. Did the defendant make misrepresentations of fact in the:

(a) July 22, 1971 opinion letter:

YES ____ NO ×

(b) October 11, 1971 opinion letter

YES × NO ____

10. If the answer to the preceding interrogatory is "YES", was the misrepresentation or misrepresentations made:

(a) with knowledge and intent to deceive, or

YES ____ NO ×

(b) recklessly:

YES × NO ____

FORESEEABILITY

11. Was it foreseeable to the defendant that purchasers of Westland Securities would be likely to suffer injury or damages as a result of misrepresentations in the opinion letter of:

(a) July 22, 1971:

YES _____ No X

(b) October 11, 1971:

YES _____ No X

12. Did the defendant exercise reasonable care in the preparation of the opinion letter of:

(a) July 22, 1971:

YES X No _____

(b) October 11, 1971:

YES _____ No X

IN THE
UNITED STATES DISTRICT COURT
FOR THE EASTERN DISTRICT OF PENNSYLVANIA

CIVIL ACTION NO. 75-1313

STANLEY L. SHARP

v.

COOPERS & LYBRAND

INTERROGATORIES TO THE JURY

1(a). Would Stanley Sharp have purchased his investment in the 1971 WMC Ohio Program for $8,125 even if the truth had been told in defendant's opinion letter?

YES _____ NO √

(b). Would H. James Conaway, Jr. have purchased his investment in the 1971 WMC Ohio Program for $8,125 even if the truth had been told in defendant's opinion letter?

YES _____ NO √

(c). Would Sam Geftic have purchased his investment in the 1971 WMC Ohio Program for $4,062 even if the truth had been told in defendant's opinion letter?

YES _____ NO √

2(a). Did Stanley Sharp fail to act with due diligence in relying on defendant's opinion letter?

YES _____ NO √

(b) Did H. James Conaway, Jr. fail to act with due diligence in relying on defendant's opinion letter?

YES _____ NO √

(c). Did Sam Geftic fail to act with due diligence in relying on Edith Wright?

YES _____ No √

3(a). Did Stanley Sharp know or in the exercise of reasonable diligence should he have known before May 7, 1974 that defendant's opinion letter contained material misrepresentations and omissions?

YES _____ No √

(b). Did H. James Conaway, Jr. know or in the exercise of reasonable diligence should he have known before May 7, 1974 that defendant's opinion letter contained material misrepresentations and omissions?

YES _____ No √

(c). Did Sam Geftic know or in the exercise of reasonable diligence should he have known before May 7, 1974 that defendant's opinion letter contained material misrepresentations and omissions?

YES _____ No √

4. What was the actual value, if any, of a ⅛ limited partnership interest in a 1971 WMC Ohio Producers Program as of late December, 1971?

$1,240

Opposition

Office - Supreme Court, U.S.
FILED
OCT 1 1981
ALEXANDER L. STEVAS
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No. 81-433

IN THE

Supreme Court of the United States

October Term, 1981

COOPERS & LYBRAND,

Petitioner

v.

STANLEY L. SHARP,

Respondent

On Writ of Certiorari to the United States Court of Appeals for the Third Circuit

BRIEF IN OPPOSITION TO PETITION FOR WRIT OF CERTIORARI

THEODORE R. MANN
BARRY E. UNGAR
LARRY H. SPECTOR
S. MARK WERNER
MANN AND UNGAR, P. A.
1711 Rittenhouse Square
Philadelphia, PA 19103
Attorneys for Respondent

International Printing Co., 711 So. 50th St., Phila., Pa. 19143 — Tel. (215) 727-5711

QUESTIONS PRESENTED FOR REVIEW

1. When an accounting partnership intends to influence prospective investors with a tax opinion letter drafted, with scienter, by a senior tax supervisor acting in the scope of his employment and reviewed, modified and signed in the partnership name by partners who fail to adequately supervise him, can the partnership be liable under section 10(b) of the Securities Exchange Act of 1934 for the fraudulent misrepresentations and omissions in the letter?

2. Can reliance be presumed in favor of plaintiffs who establish a *prima facie* case of causation in fact by showing that defendant made material omissions and material misrepresentations in a tax opinion letter with which defendant intended to influence investors and without which the investment would not have been marketed?

3. Is it within the court's discretion to award defrauded securities purchasers prejudgment interest on the amount of their out-of-pocket loss?

TABLE OF CONTENTS

	Page
QUESTIONS PRESENTED FOR REVIEW	i
TABLE OF AUTHORITIES	iii
ADDITIONAL STATUTE INVOLVED	1
STATEMENT OF THE CASE	2
REASONS FOR NOT GRANTING THE WRIT	7
I. The Respondeat Superior Issue	7
A. The Court of Appeals Did Not Decide the Broad Principle Suggested by C&L	7
B. There Is No Conflict With Decisions of This Court or the Courts of Appeals on the Fundamental Legal Principle Involved	7
C. The Third Circuit's Decision Is Not in Conflict With Decisions of This Court in *Hochfelder* or *Aaron*	10
D. Even if There Existed a Conflict Among the Circuits on Respondeat Superior, This Court Should Not Reach That Issue Because There Was Primary Liability in This Case	11
E. Review Is Unwarranted Because, Apart From the Issue of Respondeat Superior, C&L Was Also Liable as a Controlling Person Under Section 20(a)	11
II. The Reliance Issue	13
A. A Presumption of Reliance Was Fully Consistent With *Affiliated Ute* and the General Requirement That Plaintiff Prove Causation in Fact	13
III. The Pre-Judgment Interest Issue	15
A. The Award of Pre-Judgment Interest Was Not an Abuse of Discretion	15
CONCLUSION	16

TABLE OF AUTHORITIES

Cases:	Page
Aaron v. SEC, 446 U. S. 680 (1980)	10
Affiliated Ute Citizens v. United States, 406 U. S. 128 (1972)	8, 13, 14
Arrington v. Merrill Lynch, Pierce, Fenner & Smith, Inc., 651 F. 2d 615 (9th Cir. 1981)	8
Blackie v. Barrack, 524 F. 2d 891 (9th Cir. 1975), cert. denied, 429 U. S. 816 (1976)	14
Blau v. Lehman, 368 U. S. 403 (1962)	15
Cameron v. Outdoor Resorts of America, Inc., 608 F. 2d 187 (5th Cir. 1979), modified on rehearing, 611 F. 2d 105 (5th Cir. 1980)	12
Carpenter v. Harris, Upham & Co., Inc., 594 F. 2d 388 (4th Cir.), cert. denied, 444 U. S. 868 (1979)	9
Carras v. Burns, 516 F. 2d 251 (4th Cir. 1975)	8, 9
Chasins v. Smith, Barney & Co., 438 F. 2d 1167 (2d Cir. 1970)	14
DelPorte v. Shearson, Hammill & Co., Inc., 548 F. 2d 1149 (5th Cir. 1977)	12
Ernst & Ernst v. Hochfelder, 425 U. S. 185 (1976)	10
Christoffel v. E. F. Hutton & Co., Inc., 588 F. 2d 665 (9th Cir. 1978)	9
Fey v. Walston & Co., Inc., 493 F. 2d 1036 (7th Cir. 1974)	8
Gould v. American Hawaiian S. S. Co., 535 F. 2d 761 (3d Cir. 1976)	15
Hecht v. Harris, Upham & Co., 283 F. Supp. 417 (N. D. Cal. 1968), modified on other grounds, 430 F. 2d 1202 (9th Cir. 1970)	12
Holmes v. Bateson, 583 F. 2d 542 (1st Cir. 1978)	8
Holloway v. Howerdd, 536 F. 2d 690 (6th Cir. 1976)	8
Huddleston v. Herman & MacLean, 640 F. 2d 534 (5th Cir. 1981)	15
Johns Hopkins University v. Hutton, 422 F. 2d 1124 (4th Cir. 1970), cert. denied, 416 U. S. 916 (1974)	8, 9
Kamen & Co. v. Paul H. Aschkar & Co., 382 F. 2d 689 (9th Cir. 1967), cert. dismissed, 393 U. S. 801 (1968)	8

TABLE OF AUTHORITIES (Continued)

Cases (Continued): Page

Kerbs v. Fall River Industries, Inc., 502 F. 2d 731 (10th Cir. 1974) 8

Lewelling v. First California Co., 564 F. 2d 1277 (9th Cir. 1977) 8

Lewis v. Walston & Co., Inc., 487 F. 2d 617 (5th Cir. 1973) 8

Lorenz v. Watson, 258 F. Supp. 724 (E. D. Pa. 1966) 12

Marbury Management, Inc. v. Kohn, 629 F. 2d 705 (2d Cir.), cert. denied, 101 S. Ct. 566 (1980) 9

Mills v. Electric Auto-Lite Co., 396 U. S. 375 (1970) 14

Myzel v. Fields, 386 F. 2d 718 (8th Cir. 1967), cert. denied, 390 U. S. 951 (1968) 9

Paul F. Newton & Co. v. Texas Commerce Bank, 630 F. 2d 1111 (5th Cir. 1980) 8, 9, 12

Nye v. Blyth, Eastman, Dillon & Co., Inc., 588 F. 2d 1189 (8th Cir. 1978) 8

SEC v. First Securities Company of Chicago, 463 F. 2d 981 (7th Cir.), cert. denied, 409 U. S. 880 (1972) 12

SEC v. Management Dynamics, Inc., 515 F. 2d 801 (2d Cir. 1975) 8

Rochez Brothers, Inc. v. Rhoades, 491 F. 2d 402 (3d Cir. 1974), cert. denied, 425 U. S. 993 (1976) 12, 14

Schlick v. Penn-Dixie Cement Corp., 507 F. 2d 374 (2d Cir. 1974), cert. denied, 421 U. S. 976 (1975) 14

Sharp v. Coopers & Lybrand, 649 F. 2d 175 (3d Cir. 1981) 6, 12, 13, 14, 15

Straub v. Vaisman & Co., Inc., 540 F. 2d 591 (3d Cir. 1976) 8

Troyer v. Karcagi, 476 F. Supp. 1142 (S. D. N. Y. 1979) 12

Vervaecke v. Chiles, Heider & Co., Inc., 578 F. 2d 713 (8th Cir. 1978) 15

Wolf v. Frank, 477 F. 2d 467 (5th Cir.), cert. denied, 414 U. S. 975 (1973) 15

Zweig v. Hearst Corp., 521 F. 2d 1129 (9th Cir.) cert. denied, 423 U. S. 1025 (1975) 9

TABLE OF AUTHORITIES (Continued)

Statutes: Page

15 U. S. C.:
§ 78c(a)(9) 1, 9, 11
§ 78j(b) 2, 5, 7, 8, 9, 10
§ 78t(a) 5, 6, 7, 8, 9, 10, 11, 12
26 U. S. C., § 752(c) 4

Rules:
SEC Rule 10b-5 ..... 2, 5, 8, 9, 10

Authorities:
3 A. Bromberg, Securities Law Fraud: SEC Rule 10b-5, Section 8.6 at 209 14
5 A. Jacobs, The Impact of Rule 10b-5, Section 64.01[a] at 3-221 (Supp. 1980) 14

ADDITIONAL STATUTE INVOLVED

Section 3(a)(9) of the Securities Exchange Act of 1934, 15 U. S. C. § 78c(a)(9), provides:

> (a) When used in this chapter, unless the context otherwise requires—
>
> • • •
>
> (9) The term "person" means a natural person, company, government, or political subdivision, agency, or instrumentality of a government.

STATEMENT OF THE CASE

Coopers & Lybrand ("C&L") seeks review of a decision affirming that it issued a fraudulent tax opinion letter in violation of section 10(b) of the Securities Exchange Act of 1934, 15 U. S. C. § 78j(b), and SEC Rule 10b-5.

Westland Minerals Corporation (WMC) retained C&L to write a tax opinion letter which would explain to prospective limited partners in a gas and oil drilling venture that they would be entitled to an income tax deduction of twice the amount of their investment. David Wright, a C&L partner in charge of the client, assigned the drafting of the opinion letter to Herman Higgins, a senior tax supervisor in the firm and an attorney.

Six partners and associates at C&L worked with Higgins on the letter. Three of them senior to Higgins reviewed it and modified it. C&L issued the letter under its firm letterhead. The letter was signed not in the name of any individual, but in the name of the firm by a partner. For issuing the letter, C&L billed the client and was paid.

In drafting the opinion letter, Higgins' essential problem was that the double deduction would not be upheld by the Internal Revenue Service unless the partnership borrowed money on a non-recourse basis and used the funds to drill for oil and gas. A bank, however, would not likely lend money on a non-recourse basis on the security of an undrilled well in which there might or might not be oil or gas.

Higgins solved the problem by conceiving of and recommending to WMC a loan transaction which plaintiff's expert [1] later described as a complete "phony." A bank would show a loan on its books to the general partner

1. Bernard Wolfman, Professor of Taxation, Harvard Law School.

(WMC); the "loan proceeds" would be deposited in the driller's account in the same bank in the form of certificates of deposit; and the certificates would be subject to a "repayment restriction" preventing the driller from withdrawing the funds unless and until the "loan" to the general partner was repaid out of the proceeds from a successful well. As stated by plaintiff's expert "it's just a circular financing arrangement where money is never actually being lent to anybody . . . it's just playing games with numbers."

Still, a cooperative bank was needed. So to implement Higgins' recommendation WMC negotiated to and did acquire a Bahamian bank. C&L partner Wright knew of the negotiations. Yet he never asked Higgins why an oil drilling company was interested in buying a bank or whether this was the bank that WMC was planning to use to make the "loans" referred to in the draft opinion letters he and other partners were reviewing. Had he done so, he would have known, as did Higgins: (1) that the Bahamian bank was insolvent; and (2) that it was being acquired by WMC only because, in Higgins' words, it "was the only ball game in town."

Higgins then finalized the opinion letter. Wright reviewed it, modified it and signed it in the firm name. He then transmitted the letter to WMC. He did so without reviewing the underlying partnership documents or knowing whether anyone else at C&L had done so. Up to the day of trial, seven years after the event, he never even asked any of the other six partners and associates what, if anything, they knew when the letter was released.

When transmitting the letter, Wright intended it to be widely distributed to market limited partnership interests in the tax shelter program. He admitted that he fully expected potential investors to rely on his firm's tax opinion in deciding whether to purchase.

The letter was fraudulent. The first sentence asserted that the facts stated in the letter were assumed and not verified by C&L. In fact, Higgins knew that the true facts were nothing like those which were assumed. The letter recited that the driller would receive the drilling funds "in cash" provided "through partnership borrowing . . . from suitable banks or other lending agencies." In fact, no "cash" from any partnership borrowing would go to the driller for the reason set forth above, and the "suitable bank" was already known to be an insolvent Bahamian bank purchased by WMC as a vehicle for the sham loan transaction Higgins recommended.[2]

As expected, the letter was reproduced, widely distributed and used as the essential selling tool without which the limited partnership interests would not have been sold. Salesmen in WMC's marketing organization were trained to use it in presentations to investors to "lend credibility" to the investment and "overcome all of the tax objections that an investor had." Thus, for example, even though plaintiff Geftic never knew of the letter, he purchased the investment in order to get a double tax deduction from a broker whose advice to him on the tax consequences of the investment came from the letter. Plaintiff Sharp had the letter described to him by both a salesman and a business associate whose attorney and accountant each reviewed it. Plaintiff Conaway personally read it.

The jury found that C&L made material misrepresentations and omissions in the letter, and that Higgins, acting in the scope and course of his duties as a C&L

2. The letter was misleading in other respects. It failed to disclose the affiliation between WMC and the bank; that the bank was insolvent; and that the Internal Revenue Code, 26 U. S. C. § 752(c), required that the collateral be equal in value to the amount of the loan.

employee, caused the misrepresentations and omissions with scienter. Although it found that no partner of C&L acted with scienter, it found that C&L had the power to control Higgins and that it did not exercise good faith through reasonably adequate and sufficient supervision over his activities.

The trial court entered judgment against C&L for violating section 10(b) under the principle of respondeat superior, and for violating the controlling persons provision, section 20(a) of the Securities Exchange Act of 1934, 15 U. S. C. § 78t(a). On the section 10(b) claim, the court reasoned that when an accounting firm earns fees for issuing a tax opinion letter in the firm name, for the purpose of influencing potential investors, it has an especially stringent duty to supervise those who draft such letters while in the scope of their employment.

On the section 20(a) claim, the trial court held that it was plaintiffs' burden to prove that defendant had the power to control Higgins. Given such power, it was defendant's burden to prove that it acted in good faith. The jury's finding of such power to control and its finding of lack of good faith made C&L liable for Higgins' conduct. The court also ruled that, to the extent plaintiffs had the burden of proving "culpable participation" of the controlling person under section 20(a), such culpable participation existed as a matter of law.

The Third Circuit affirmed the respondeat superior liability under section 10(b), on the same basis as the trial court. Emphasizing the "limited situation" which justified its holding, the court ruled that where an accounting firm knows and intends that its opinion letter will influence the investing public, it has a responsibility to "exercise stringent or high supervision of its employees, and failure to perform this duty will expose it to liability for their violations of rule 10b-5 under the doctrine of respondeat

superior." *Sharp v. Coopers & Lybrand*, 649 F. 2d 175, 185 (3d Cir. 1981).

On the section 20(a) claim, however, the Third Circuit held that "culpable participation" should not have been decided as a matter of law, but should have been submitted to the jury.

REASONS FOR NOT GRANTING THE WRIT

I. The Respondeat Superior Issue.

A. The Court of Appeals Did Not Decide the Broad Principle Suggested by C&L.

Contrary to the suggestion made by C&L, the Third Circuit did not hold that an employer is subject to strict liability under section 10(b) of the Securities Exchange Act in accordance with common law principles of respondeat superior. Nor did it hold that section 10(b) "overrides" section 20(a). It held merely that where an accounting firm intends to influence prospective investors with a tax opinion letter drafted, with scienter, by a senior tax supervisor acting in the scope of his employment and reviewed, modified and signed in the partnership name by partners who failed to adequately supervise him, the firm can be liable under section 10(b) for the fraudulent misrepresentations and omissions in the letter. The limited nature of the court's holding was made explicit:

> "A simple garden variety master-servant relationship is not what activates the doctrine of respondeat superior in this case. Rather, the presence of what we described in *Rochez II* as a 'stringent' or high duty to supervise employees triggers the doctrine. At common law, the misrepresentations of an employee, even those made fraudulently without the employer's knowledge, will render any employer liable for damages to persons experiencing harm as a result. . . . Our decision does not go so far." 649 F. 2d at 184.

B. There Is No Conflict With Decisions of This Court or the Courts of Appeals on the Fundamental Legal Principle Involved.

This Court and every Court of Appeals agree with the decision of the Third Circuit that there are circumstances

where an employer will be held liable for the acts of its employee under section 10(b), notwithstanding the existence of section 20(a).[3]

In *Affiliated Ute Citizens v. United States*, 406 U. S. 128 (1972), defendants Gale and Haslem, bank employees, were found liable for violating Rule 10b-5. Without any reference to section 20(a), this Court stated: "The liability of the Bank of course is co-extensive with that of Gale and Haslem." 406 U. S. at 154.

Even the Ninth Circuit, whose decisions are principally relied upon by C&L, has affirmed liability under section 10(b) for a business entity which acted through employees acting within the scope of their employment. *See Arrington v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 651 F. 2d 615 (9th Cir. 1981); *Lewelling v. First California Co.*, 564 F. 2d 1277 (9th Cir. 1977). *Kamen & Co. v. Paul H. Aschkar & Co.*, 382 F. 2d 689 (9th Cir. 1967), *cert. dismissed*, 393 U. S. 801 (1968) and the two other Ninth Circuit decisions which followed *Kamen* are not to the contrary. First, they did not involve a fraudulent document issued in the firm name for advancement of

3. *See Holmes v. Bateson*, 583 F. 2d 542, 560 (1st Cir. 1978); *SEC v. Management Dynamics, Inc.*, 515 F. 2d 801, 812-813 (2d Cir. 1975) (Kaufman, C. J.); *Straub v. Vaisman & Co., Inc.*, 540 F. 2d 591, 595-596 (3d Cir. 1976); *Carras v. Burns*, 516 F. 2d 251, 259 (4th Cir. 1975); *Johns Hopkins University v. Hutton*, 422 F. 2d 1124, 1130 (4th Cir. 1970), *cert. denied*, 416 U. S. 916 (1974); *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F. 2d 1111, 1118-1119 (5th Cir. 1980); *Lewis v. Walston & Co., Inc.*, 487 F. 2d 617, 623-624 (5th Cir. 1973) (Wisdom, J.); *Holloway v. Howerdd*, 536 F. 2d 690, 694-695 (6th Cir. 1976); *Fey v. Walston & Co., Inc.*, 493 F. 2d 1036, 1052-1053 (7th Cir. 1974); *Nye v. Blyth, Eastman, Dillon & Co., Inc.*, 588 F. 2d 1189 (8th Cir. 1978); *Arrington v. Merrill Lynch, Pierce, Fenner & Smith, Inc.*, 651 F. 2d 615 (9th Cir. 1981); *Kerbs v. Fall River Industries, Inc.*, 502 F. 2d 731, 740-741 (10th Cir. 1974).

firm business. Second, they never discussed whether an employer could be liable for the authorized conduct of its employee.[4]

The unanimity of the courts on this issue is dictated by the language of section 10(b) itself which states that "it shall be unlawful for any *person* . . . to use . . . any manipulative or deceptive device. . . ." (emphasis added). The term "person" is expressly defined in section 3(a)(9) of the Act to include any "company", 15 U. S. C. § 78c (a)(9). Inasmuch as a company can never act except through its employees in the scope of their duties, there are obviously circumstances where a company is liable for

4. *Christoffel v. E. F. Hutton & Co., Inc.*, 588 F. 2d 665 (9th Cir. 1978) and *Zweig v. Hearst Corp.*, 521 F. 2d 1129 (9th Cir.) *cert. denied*, 423 U. S. 1025 (1975) simply rely on *Kamen, without discussing* the respondeat superior issue. In *Kamen*, the court found that the employees of the defendant brokerage firm did not have apparent authority vis-a-vis the plaintiffs they defrauded. It thus found that the *facts* could not support liability based on traditional agency principles. It never discussed or held that respondeat superior could not apply as a matter of law. *See Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F. 2d 1111, 1117, n. 5 (5th Cir. 1980).

Nor is there any conflict with decisions of the Fourth or Eighth Circuits. *Carpenter v. Harris, Upham & Co., Inc.*, 594 F. 2d 388 (4th Cir.), *cert. denied*, 444 U. S. 868 (1979) did not even cite, let alone overrule, Fourth Circuit precedent permitting the application of respondeat superior under Rule 10b-5. *Johns Hopkins University v. Hutton*, 422 F. 2d 1124, 1130 (4th Cir. 1970), *cert. denied*, 416 U. S. 916 (1974); *Carras v. Burns*, 516 F. 2d 251, 259 (4th Cir. 1975). The Eighth Circuit, in *Myzel v. Fields*, 386 F. 2d 718 (8th Cir. 1967), *cert. denied*, 390 U. S. 951 (1968), did not hold that section 20(a) preempts respondeat superior. It noted that, apart from section 20(a), "under common law principles, a principal is liable for the deceit of his agent committed in the very business he was appointed to carry out." *Id.* at 738; *see Marbury Management, Inc. v. Kohn*, 629 F. 2d 705, 714 (2d Cir.), *cert. denied*, 101 S. Ct. 568 (1980).

the acts of its employees under section 10(b); otherwise liability of a "company" would be read out of the Act.

The issue, then, raised by the Third Circuit's decision is not whether an employer can be liable under section 10(b) for acts of employees, because clearly it can. The issue is the application of that principle to the facts of this case. Precisely because the issue is the application of the principle, and not the principle itself, this case is inappropriate for review. Experience with varying factual circumstances in the lower courts is already resulting in a resolution of when primary liability under section 10(b) exists for employee conduct, when respondeat superior applies, and when section 20(a) alone applies.[5]

C. The Third Circuit's Decision Is Not in Conflict With Decisions of This Court in *Hochfelder* or *Aaron*.

Application of respondeat superior in this case is not contrary to the holdings of *Ernst & Ernst v. Hochfelder*, 425 U. S. 185 (1976) and *Aaron v. SEC*, 446 U. S. 680 (1980). Those cases held only that scienter is a necessary element of a Rule 10b-5 violation. They did not even consider the question involved here, *viz.*, the circumstances under which an employer can be liable for a violation of Rule 10b-5 because of the scienter of its employees acting in the scope of their authority.

There is no absence of scienter in this case. The jury found that Higgins had it. A "company" can only have

5. The facts render moot C&L's argument that the application of respondeat superior is contrary to the design of the Act, because it denies the defendant the right to prove "good faith," a partial defense available to controlling persons under section 20(a). No purpose would be served by considering that argument in this case, because C&L was given an opportunity to prove good faith, and the jury specifically found that it failed to do so.

the state of mind of the individual it selects to act on its behalf.

D. Even if There Existed a Conflict Among the Circuits on Respondeat Superior, This Court Should Not Reach That Issue Because There Was Primary Liability in This Case.

This is not a case of secondary liability. The tax opinion letter was the letter of C&L, not of any employee of C&L. It was communicated to investors not through Higgins or any other single firm employee, but through selling agents as the opinion of C&L. Investors and salespersons saw the opinion only as the opinion of C&L and relied on the reputation and integrity of that firm. As previously stated, artificial entities can only have scienter through their employees, whom they authorize to act on their behalf. C&L was not held responsible for an employee acting for his own account, but for company conduct for the benefit of the firm. Under such circumstances there is no reason why C&L's liability in this case should be based on respondeat superior or any other theory of secondary or vicarious liability. Its liability was *primary* as a "person", as that term is defined in section 3(a)(9) of the Act, 15 U. S. C. § 78c(a)(9), and that liability flowed from the collective conduct of high level employees and partners acting in the firm name and in the scope of firm business.

E. Review Is Unwarranted Because, Apart From the Issue of Respondeat Superior, C&L Was Also Liable as a Controlling Person Under Section 20(a).

The Third Circuit ruled that "culpable participation" of the controlling person is an element of the section 20(a) offense which should have been submitted to the jury as an issue of fact, rather than ruled upon by the district

court as a matter of law. *Sharp*, 649 F. 2d at 185. This ruling ignored the jury's express finding that C&L had the power to control Higgins' wrongful activities and that it failed to adequately supervise him. Under the circumstances of this case, those findings should have been determinative of section 20(a) liability, thus eliminating the need for any additional factual finding of "culpable participation" as a prerequisite to C&L's liability as a controlling person.

Lack of adequate supervision is itself a form of "culpable participation" that has been repeatedly held sufficient to impose section 20(a) liability.[6] Especially should this be true where, as here, the defendant, through seven partners and associates, creates in prospective investors an expectation of trust and confidence by circulating an opinion letter in its firm name intending that they rely upon it; yet does so without the slightest inquiry to the draftsmen of the letter on whether its factual assumptions are *bona fide*.

In this case culpable participation should have been premised on the jury finding of lack of good faith alone, and section 20(a) should have provided an alternative ground for C&L's liability.

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6. *Paul F. Newton & Co. v. Texas Commerce Bank*, 630 F. 2d 1111, 1120 (5th Cir. 1980); *Cameron v. Outdoor Resorts of America, Inc.*, 608 F. 2d 187, 194-95 (5th Cir. 1979), *modified on rehearing*, 611 F. 2d 105 (5th Cir. 1980); *DelPorte v. Shearson, Hammill & Co., Inc.*, 548 F. 2d 1149, 1154 (5th Cir. 1977); *Rochez Brothers, Inc. v. Rhoades*, 491 F. 2d 402, 413 n. 20 (3d Cir. 1974), *cert. denied*, 425 U. S. 993 (1976); *SEC v. First Securities Company of Chicago*, 463 F. 2d 981, 987 (7th Cir.), *cert. denied*, 409 U. S. 880 (1972); *Troyer v. Karcagi*, 476 F. Supp. 1142, 1150-51 n. 12 (S. D. N. Y. 1979); *Hecht v. Harris, Upham & Co.*, 283 F. Supp. 417, 438-39 (N. D. Cal. 1968); *modified on other grounds*, 430 F. 2d 1202 (9th Cir. 1970); *Lorenz v. Watson*, 258 F. Supp. 724, 732-733 (E. D. Pa. 1966).

II. The Reliance Issue.

A. A Presumption of Reliance Was Fully Consistent With *Affiliated Ute* and the General Requirement That Plaintiff Prove Causation in Fact.

The jury found, and the Third Circuit agreed, that the C&L opinion letter contained both misrepresentations and omissions of material facts. The Third Circuit, again focusing on the fact that C&L intended its letter to influence the investment decisions of prospective purchasers, held that reliance was properly presumed in favor of each plaintiff. *Sharp*, 649 F. 2d at 189.

The presumption of reliance issue is an evidentiary question that has nothing to do with the liability creating conduct in this case. Yet, C&L urges the Court to decide whether the presumption was improperly granted, because the lower court did not first determine whether misrepresentations or omissions predominated in the opinion letter.

Preliminarily, we note the anomaly of an argument that concedes a presumption of reliance to a plaintiff who proves only material omissions, but denies it to the plaintiff who proves further that separate facts were also misrepresented. The plaintiff should not be penalized for proving the compound nature of a defendant's fraud.

In any event, the treatment of the reliance issue was totally consistent with *Affiliated Ute Citizens v. United States*, 406 U. S. 128 (1972). "Under the circumstances of [that] case" positive proof of reliance was unnecessary because the materiality of the nondisclosed facts established "the requisite element of causation in fact." *Id.* at 154. In *Sharp*, causation in fact was established *prima facie* through materiality (the jury found that the letter contained both material misrepresentations and material

omissions) and by other evidence of causation.[7] As did the defendant in *Affiliated Ute*, C&L "facilitated the transactions at issue but failed to disclose certain [material] facts." *Sharp*, 649 F. 2d at 189. Its letter was the key selling tool without which the entire program could not have been marketed. In addition, it was used to train all sales representatives who sold the tax shelter, and their explanations of the tax consequences of the investment were derived from the letter.

Such evidence established causation in fact for each plaintiff. Granting a presumption of reliance under these circumstances was therefore only a recognition that plaintiffs had met their burden of production on the causation issue, and thereby shifted to defendant the burden of showing that even had the true facts been stated in the letter, each investor would still have purchased. *See Rochez Brothers, Inc. v. Rhoades*, 491 F. 2d 402, 410 (3d Cir. 1974), *cert. denied*, 425 U. S. 993 (1976). The jury specifically found that C&L had not met that burden.

There is no conflict between the circuits on the fundamental principle that in order to obtain the benefit of a presumption, a plaintiff must establish, *prima facie*,

7. Personal reliance is simply one way of proving that defendant's conduct caused plaintiffs to enter their securities transactions. Causation, not reliance, is therefore the ultimate issue. *Sharp v. Coopers & Lybrand*, 649 F. 2d at 186 (reliance is "one aspect" of causation requirement); *Blackie v. Barrack*, 524 F. 2d 891, 906 n. 22 (9th Cir. 1975), *cert. denied*, 429 U. S. 816 (1976) (reliance is a "mile post" along the way to causation); *Schlick v. Penn-Dixie Cement Corp.*, 507 F. 2d 374, 380-81 (2d Cir. 1974), *cert. denied*, 421 U. S. 976 (1975) (requiring "transaction causation"); 5 A. Jacobs, *The Impact of Rule 10b-5*, Section 64.01[a] at 3-221 (supp. 1980); 3 A. Bromberg, *Securities Law Fraud: SEC Rule 10b-5*, Section 8.6 at 209 (reliance and causation are no longer clearly distinguishable requirements); *Mills v. Electric Auto-Lite Co.*, 396 U. S. 375, 385 (1970); *Chasins v. Smith, Barney & Co.*, 438 F. 2d 1167, 1172 (2d Cir. 1970).

causation in fact. The Third Circuit's analysis simply represents a more "flexible approach" to the reliance issue than that taken by the Fifth Circuit in *Huddleston v. Herman & MacLean*, 640 F. 2d 534 (5th Cir. 1981), criticized in *Sharp*, 649 F. 2d at 189, as suffering from the difficulty of trying to "pigeon-hole" facts into discrete categories. In *Vervaecke v. Chiles, Heider & Co., Inc.*, 578 F. 2d 713 (8th Cir. 1978) (C&L's Br. 22), plaintiff made no "initial showing of reliance" and actually disproved reliance by establishing that his purchase decision was "influenced primarily by factors personal to him and unrelated to the alleged misrepresentations and omissions." *Id.* at 717-719. There was a complete "lack of support" for "causation in fact between the fraud complained of and Vervaecke's loss." *Id* at 719. There is no doubt that the Third Circuit would have decided *Vervaecke* precisely as did the Eighth Circuit.

III. The Pre-Judgment Interest Issue

A. The Award of Pre-Judgment Interest Was Not an Abuse of Discretion.

A decision whether to award pre-judgment interest to a Rule 10b-5 plaintiff is to be based on fairness and is within the discretion of the trial court. *Gould v. American Hawaiian S. S. Co.*, 535 F. 2d 761, 784-85 (3d Cir. 1976); *Wolf v. Frank*, 477 F. 2d 467, 479 (5th Cir.), *cert. denied*, 414 U. S. 975 (1973). *See also, Blau v. Lehman*, 368 U. S. 403, 414 (1962). Defendant confounds a discount factor applied in order to determine each investor's 1971 out-of-pocket loss, with interest awarded because investors have now been without their funds for ten years. The discount factor was applied to the amount of return an average investor would have received over the life of a well, in order to determine the 1971 value of that prospective

return; that amount was then deducted from the amount of the investor's 1971 investment, in order to establish his 1971 loss. Pre-judgment interest was then awarded on that loss.

CONCLUSION

For the reasons set forth above, the Petition for Writ of Certiorari should be denied.

Respectfully submitted,

THEODORE R. MANN
BARRY E. UNGAR
LARRY H. SPECTOR
S. MARK WERNER
MANN AND UNGAR, P. A.
1711 Rittenhouse Square
Philadelphia, Pa. 19103
(215) 732-3120
Attorneys for Respondent

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